

104
BUDGET AND ECONOMIC OUTLOOK

Y 4. B 85/3: 104-3

Budget and Economic Outlook, Serial...

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9958

HEARING
BEFORE THE
COMMITTEE ON THE BUDGET
HOUSE OF REPRESENTATIVES
ONE HUNDRED FOURTH CONGRESS
FIRST SESSION

HEARING HELD IN WASHINGTON, DC, JANUARY 31, 1995

Serial No. 104-3



MAY 23 1995

Printed for the use of the Committee on the Budget

U.S. GOVERNMENT PRINTING OFFICE

87-930

WASHINGTON : 1995

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-046948-1

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BUDGET AND ECONOMIC OUTLOOK

TUESDAY, JANUARY 31, 1995

HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 10:33 a.m., in room 210, Cannon House Office Building, Hon. John R. Kasich (chairman of the committee) presiding.

Representatives present: Kasich, Hobson, Kolbe, Shays, Herger, Bunning, Allard, Miller, Lazio, Franks, Smith of Michigan, Molinari, Nussle, Hoekstra, Largent, Brownback, Radanovich, Bass, Sabo, Stenholm, Coyne, Costello, Orton, Pomeroy, Browder, Woolsey, Olver, Roybal-Allard, Meek, Rivers, and Doggett.

Chairman KASICH. Let me just go ahead and call the committee to order, and Martin will be in here. Because what I need to do right after that is to ask if Mr. Doug Jamerson is in this room. Where is Doug? Where is he? Stand up. He is a constituent of Carrie Meek. He is the Secretary of the Department of Labor and he lives in Tallahassee, FL. Obviously, he works for Lawton Chiles, so we want to welcome you here this morning, sir. I know that Ms. Meek wanted me to recognize you, and we are glad that you are with us.

Mr. JAMERSON. Thank you, Mr. Chairman.

Chairman KASICH. If there is any way you can bring some warm weather—you did not bring all the warm weather here with you this morning we would like. So when you get there, push it like this when you get back and get it up here for us.

Thank you, sir.

I want to welcome Dr. Reischauer. Everybody, of course, is stunned that he still is in office, but it will not be forever. Let me just make that announcement. As Mark Twain says, his demise has not occurred yet, but it is about to in some period of time. I consider Dr. Reischauer to be really a very good man. As I said in the joint hearing, he has served his country well.

Doctor, I want to tell you that I think that there have been some—you are going to be shocked when I tell you. We have been out across the country with the Budget Committee. We were in Columbus, OH, and we had somewhere around 1,500 people show up on a Saturday afternoon, with 6 inches of snow on the ground, and it looked like there would be 60. They showed up and they did not practice NIMBY. They were willing to stand up and talk about what they were willing to give.

Last weekend, we were in Prescott, AZ, and we had about 1,000 people, 300 stand out on the corner to get in and give us their advice, and 650 in the auditorium.

You kind of always have to have a little prop. I brought these letters. Now, this is going to be really shocking to you. I can bring a lot more. I have got to get more. If this was "Letterman," I would have more.

These are letters from people saying cut the budget, cut spending. It is really my sense that the American people—I know in your testimony, you talk about the importance of getting to a balanced budget. I know you are going to talk about the fact that these deficits are going to explode in the outyears, and I think different than what we have seen in this country before.

What we saw in the 1980's were people basically still believe in government or the fact that they always said cut somebody else, don't cut me. I really believe there is a change in attitude. We heard it out there in Prescott. Jim Nussle was there, along with Bob Franks, and it was kind of like a Nike commercial, just do it is what they were saying, just do it, have the guts to do the right thing and get everybody involved. John Shadegg was there, as well.

So I think if we can be creative and innovative and listen to what people are saying outside the beltway, we can get this job done. The challenge will be to come up with the good policy, which I think the options are there, and to dismiss the politics. My sense is that we can in fact get this budget balanced, which I believe will secure a better economic future for the next generation.

So I am here with an optimistic view today about what we are hearing as we are going across the country. We will be in Columbia, SC, this weekend, and then we will end up in Manville, NJ, and we would invite you to go with us to balmy Billings, MT, where temperatures are known to be hit 30 below zero. So we are looking forward to this.

I want to welcome you here this morning for what has become traditional testimony by the CBO Director. I again thank you for your service.

I will now recognize the gentleman from Minnesota, Mr. Sabo.

Mr. SABO. Thank you, Mr. Chairman.

I would like also to extend my welcome to Bob. I want to say Dr. Reischauer, but all of us know him as Bob. We have lots to discuss today, and that is why I am glad that we will be hearing from you. Your views are always welcome and respected by members of this committee. And as we move forward into what looks to be an especially difficult budget process, I am sure your views will be even more carefully considered.

First, I want to thank you for your years of service to Congress and the American public. As Director of the CBO, you have provided this committee and Members of Congress with valuable budget and economic information.

While I have not always agreed with your decisions, you have always operated with integrity and intellectual honesty. I have greatly appreciated your service to me, the committee and this institution. Quite frankly, I am still waiting for a CBO ruling that might have helped. They always seem to complicate it, but they were honestly arrived at.

As we look ahead to the budget process this year, we need to put things in context. In the last session of Congress, we made great strides in bringing the deficit down. Because of the 1993 Budget Act, we will see 3 straight years of falling deficits for the first time since Harry Truman was in the White House. Further, this year's deficit will be the lowest it has been relative to the economy since 1979.

Now, the House has passed a balanced budget constitutional amendment. We will be faced with many tough issues. If we are not scrupulously honest with the American people about our budget process this year, we could turn a fiscal problem into a constitutional crisis. I am greatly concerned that the ambitious and contradictory agenda contained in the Contract With America will tempt some to rely on overly optimistic economic assumptions in order to achieve the contract's goals. As we learned in the 1980's, "rosy scenarios" can do much to advance political goals, but when economic forecasts are even slightly overoptimistic, they can explode the budget deficit.

Another area of deep concern to me that CBO could help us with is the tax package in the contract, which appears to escalate in cost dramatically outside of the 5-year budget time frame. If we are going to have a balanced budget by the year 2002, it is critically important that we not design tax and spending packages that explode in cost down the road. I think CBO's assessment of these types of outyear costs will be very important to our budget deliberations.

The combination of a promise to balance the budget and the new unfunded mandate legislation currently moving on the House floor is another example of the risks and internal contradictions in the contract. The mandate legislation has huge budgetary implications. It has the potential to explode the deficit by requiring the Federal Government to pay the entire cost of new protections demanded by the public and by preventing cuts in existing programs. This legislation also greatly expands the responsibilities of the CBO, and you may want to comment on that.

Finally, you stated in your report that if we balance the budget, interest rates will come down—in effect, creating a "debt service bonus" in the Federal budget. I share your view that balancing the budget could have a positive impact on interest rates.

However, I believe if the budget is balanced under some constitutional requirement or threat, this "bonus" will not be realized, because it is in the nature of politicians not to subject themselves to chance in mandated situations. I believe that we will have to convert all our Federal debt to long-term debt, rather than place ourselves at the mercy of the international bond dealers. Since long-term debt is typically more expensive than short-term debt, the net effect of this change will be an increase in Federal interest costs, rather than a decrease.

Again, I feel it is important that as we work to construct a Federal budget, we work for changes that result in long-term, steady deficit reduction. We need to be wary of packages that look good on their face, but actually send the deficit soaring later on.

Thank you again, Mr. Chairman. Thank you for coming, Dr. Reischauer, and I look forward to your testimony.

Chairman KASICH. I would just like to say to the gentleman from Minnesota that I think his opening statement makes some very important points and we will think about them. I want to compliment the gentleman on his statement, not that I agree with it all, but it is definitely food for thought.

Dr. Reischauer, it is now your turn.

**STATEMENT OF DR. ROBERT D. REISCHAUER, DIRECTOR,
CONGRESSIONAL BUDGET OFFICE**

Mr. REISCHAUER. Thank you, Mr. Chairman and Mr. Sabo, for your kind opening remarks. I appreciate the opportunity to appear before this committee.

I was encouraged by the letters that you have received, Mr. Kasich. I receive many of those letters myself and I always say I have no responsibility for this and write your Congressman. You are a Member of Congress, and I am glad to say that the people are doing that and, given the size of that stack of mail, we might have to go back and revise our estimate for the Postal Service budget situation.

With your permission, I would like to submit my prepared statement for the record and summarize for you the Congressional Budget Office's [CBO] new economic and budget outlooks. I will also say a few words about the challenge involved in balancing the Federal budget by the year 2002, which might be required if the proposed amendment to the Constitution is passed by the House and Senate and ratified by three-quarters of the States.

With respect to the economy, CBO expects the strong growth that was experienced throughout 1994 to continue only slightly abated in the first half of 1995. Because the economy is operating close to its potential, that growth will increase inflationary pressures and is likely to trigger additional efforts by the Federal Reserve Board to rein in the economy with higher short-term interest rates.

As a result of such monetary tightening and the rate hikes that have already occurred, the economy will slow down toward the end of 1995 and during 1996. On a fourth-quarter-to-fourth-quarter basis, real economic growth was 4 percent in 1994. CBO expects the economy to grow at 2.5 percent this year, and 1.9 percent during 1996.

In 1994, more than 3 million new jobs were created and the unemployment rate fell to an average of 6.1 percent. The unemployment rate should average about 5.5 percent during 1995, and then inch up a bit to 5.7 percent in 1996 as a result of the slowdown in the economy. Both of these figures are below CBO's 6 percent estimate of the rate of unemployment that is compatible with nonaccelerating inflation. In other words, in CBO's judgment, actual output is exceeding its potential.

Consequently, although inflation has been quite subdued over the past 2 years, averaging about 2.8 percent per year, CBO expects inflation to pick up modestly. The Consumer Price Index for all urban consumers is forecast to increase to 3.2 percent in 1995 and 3.4 percent in 1996.

Over the course of 1994, the Federal Reserve tightened monetary policy. The 90-day Treasury bill rate rose from 3.2 percent in the

first quarter of 1994 to 5.3 percent in the fourth quarter, and the rate on 10-year notes rose from 6.1 percent to 7.8 percent. CBO expects the Federal Reserve to continue tightening monetary policy in the first part of this year, with rates on bills and notes averaging 6.2 percent and 7.7 percent respectively in 1995. Rates should fall a bit in 1996 as a result of the economic slowdown.

CBO's forecast implies that the Federal Reserve's efforts to restrain the economy will slow it without causing a recession. Other outcomes, however, are possible. If the economy overshoots its potential by a wider margin than CBO now anticipates, the Federal Reserve might take more drastic actions which could foreshadow a recession next year or the year after. Alternatively, the rise in interest rates that has already occurred may have been enough to slow the economy significantly. CBO's forecast is a compromise between those two scenarios and is similar to that of the consensus of private economists.

With respect to the budget outlook, CBO expects the deficit for the current fiscal year to fall to \$176 billion or 2.5 percent of GDP. In dollar terms, that will be the lowest level since 1989. In relation to gross domestic product [GDP], it is the lowest figure since 1979.

Nevertheless, if the Congress does not adopt additional policies to reduce the deficit, the 3 consecutive years of declining deficits that we have enjoyed will come to an end and the deficit will begin to rise again in 1996. The mounting deficits will be fueled primarily by increases in Medicaid and Medicare, which are expected to rise by roughly 10 percent a year. Spending on all other programs except Medicare and Medicaid is expected to grow at only about one-half of that rate.

By 2005, the deficit is projected to reach \$421 billion, or 3.6 percent of GDP, if one assumes that discretionary spending will be adjusted for inflation after the discretionary caps expire in 1998. On the other hand, if discretionary spending is frozen at 1998 levels when the caps expire, the deficit would be only \$242 billion or 2.1 percent of GDP in the year 2005.

However, the funds available for discretionary programs in 2005 would have only 73 percent of the purchasing power of the 1995 appropriations. If defense accounts were protected from the insidious effects of inflation over this period, the money available for all discretionary programs in 2005 would have less than half of the purchasing power of the 1995 appropriations for those programs.

Those projections hint at some of the tough choices that will have to be made to balance the budget by 2002. According to CBO's projections, some accommodation of spending cuts and tax increases totaling \$322 billion in 2002 would be needed to eliminate the deficit in that year.

There are many possible paths to this objective, one of which I have presented to you on the last page of my prepared statement. That path first freezes discretionary spending through 2002 at the dollar level of the 1998 cap. That action, together with the resulting lower debt service costs, would produce \$89 billion of the \$322 billion in savings needed to balance the budget in 2002. Under that policy, the buying power of discretionary appropriations in 2002 would be about 20 percent less than the amount provided in real terms in 1995.

The illustrative path next assumes further savings from policy changes that are similar in pattern to that of the mandatory program savings that were contained in the reconciliation bills of 1990 and 1993. If those savings were achieved entirely out of entitlement and other mandatory programs, excluding Social Security, they would represent about a 20-percent reduction from current policy levels for those programs.

In the period from 1996 through 2002, the savings in CBO's illustrative path that result directly from policy changes would total a bit more than a trillion dollars, and the associated debt service savings would amount to about \$175 billion. But that picture probably overstates somewhat the severity of the required cuts that are related to changes in policy. If the policy changes required to balance the budget are enacted into law soon and financial markets are convinced that policymakers will stay the course, CBO expects that interest rates would fall below those in its forecast. That drop would increase the debt service savings and reduce the amount of savings needed from policy changes.

If by the year 2000 interest rates were to fall by as much as 1 percentage point below the levels that were assumed by CBO, which is quite plausible, the amount of savings needed over the 1996-2002 period from policy changes would be almost \$140 billion less than the \$1.035 trillion that is shown in the table in my prepared statement.

I have testified many times before this committee on the long-run economic benefits of reducing the deficit. Productivity would increase, living standards would rise, the economy would be less dependent on foreigners for future investment, and our debt-to-GDP ratio would begin to decline.

But in economic terms, the road to a balanced budget would be one we have never traveled before. It would involve sustained fiscal restraint averaging roughly .04 percent of GDP a year. The contractionary effects of that restraint would be offset to some degree by lower interest rates stemming from reduced Federal credit demands, possible monetary easing by the Federal Reserve, and stronger exports brought on by lower exchange rates. Nevertheless, there could be a few bumps along that road to a balanced budget.

Let me conclude by noting that the magnitude of the discretionary and mandatory cuts contained in the illustrative path to a balanced budget are large, but they are not unattainable. Their size could be reduced, of course, if tax increases were considered part of the equation. If tax cuts, however, are offered, deeper spending cuts will be required.

Irrespective of the outcome of that debate, the effort to balance the budget should trigger some much-needed rethinking about the activities that the Federal Government should continue to pursue and those which in times of fiscal retrenchment are better left to other levels of government or to the private sector. That, I think, should be the focus of the debate in the Congress over the course of the next few months.

I thank you and I will be happy to answer any questions that members of the committee might have.

[The prepared statement of Mr. Reischauer follows:]

PREPARED STATEMENT OF DR. ROBERT D. REISCHAUER, DIRECTOR, CONGRESSIONAL
BUDGET OFFICE

Chairman Kasich, Congressman Sabo, and Members of the Committee, I am pleased to be with you this morning to review the state of the economy and the budget. Tomorrow, the Congressional Budget Office (CBO) will publish *The Economic and Budget Outlook: Fiscal Years 1996-2000*, which describes our current views in considerable detail. We have provided advance copies for the Committee. My testimony summarizes that report.

No fundamental change in the economic or budget situation has occurred since CBO published *The Economic and Budget Outlook: An Update* in August 1994. The economy may be a bit more robust in 1995 than had been anticipated at that time, but a likely slowdown in growth in 1996 leaves the long-term economic outlook little different from last summer's. CBO expects that the high levels of business investment and purchases of durable goods that spurred the economy to a 4.0 percent real rate of growth in 1994 will continue into the first part of 1995. Because the economy is already operating close to its potential (the level of gross domestic product, or GDP, consistent with a stable rate of inflation), that growth is expected to result in somewhat higher rates of inflation and interest. In turn, those higher interest rates are likely to slow growth by the end of 1995--cutting it to 2.5 percent in 1995 and 1.9 percent in 1996 and dampening inflationary pressures. In CBO's longer-term projections, average annual growth after 1996 is close to the 2.4 percent rate of growth estimated for potential GDP; over the 1997-2000 period covered by those projections, inflation averages 3.4 percent and interest rates drift down.

CBO projects that the deficit will decline from the \$203 billion registered in 1994 to \$176 billion in 1995, the lowest level since 1989 and the lowest as a percentage of GDP (2.5 percent) since 1979. After reaching a trough in 1995, the deficit will rise to \$207 billion in 1996 (2.8 percent of GDP), grow again in 1997, and then level off in 1998. Those projections assume no change in current policies governing taxes and mandatory spending; they also assume compliance with the limits on discretionary appropriations that are in place through 1998. Under the assumption that spending for discretionary programs increases at the rate of inflation after 1998, deficits will grow to \$284 billion (3.1 percent of GDP) in 2000, the last year of CBO's regular projections. Under an alternative baseline that assumes that discretionary spending remains frozen at the dollar level of the 1998 caps, deficits increase only to \$243 billion in 2000.

CBO's extended projections for 2001 through 2005, which are less detailed than those through 2000, show deficits continuing to mount in dollar terms through 2005 if discretionary spending is adjusted for inflation after 1998 (see Figure 1 at the end of this statement). Deficits also grow as a percentage of GDP--to 3.6 percent in 2005. There is no reason to believe that this trend will be reversed in the years after that; indeed, the growth in the deficit is likely to accelerate in the second decade of the 21st century as large numbers of baby boomers become eligible for Social Security and Medicare benefits. Extended baseline projections that assume that discretionary spending is frozen at the 1998 level show deficits that are nearly constant from 2000

through 2005. As a percentage of GDP, the deficit in that baseline shrinks from 2.7 percent in 1998 to 2.1 percent in 2005.

Higher-than-anticipated interest payments and lower revenues, which are only partially offset by lower spending for medical care programs, have pushed up CBO's deficit projections for fiscal years 1995 through 1999 from last August's estimates by an average of almost \$25 billion a year. After 2002, however, the deficits in the new extended projections are a little lower than the deficits projected in August.

The Congress is considering a constitutional amendment, which could go into effect as early as 2002, requiring a balanced budget. CBO currently projects a deficit of \$322 billion for that year (assuming that discretionary spending is adjusted for inflation after 1998), which is only \$3 billion more than the amount estimated last August. To illustrate the magnitude of the task facing those who would have to enact policies to comply with the balanced budget requirement, CBO has constructed an illustrative path leading to a balanced budget in 2002 that entails deficit reduction of \$1.2 trillion over the 1996-2002 period. Major changes in current policies would be required to achieve deficit reduction on that scale.

THE ECONOMIC OUTLOOK

CBO forecasts that the strong economic growth that the nation experienced throughout 1994 will continue only slightly abated into the first part of 1995. Because the economy is operating close to its potential, that growth will increase inflationary pressures and is likely to trigger additional efforts by the Federal Reserve Board to rein in the economy with higher short-term interest rates. In the CBO forecast, the resulting moderate slowdown at the end of 1995 and during 1996 will gradually bring GDP back in line with potential output without seriously disrupting the economy. Even with somewhat higher short-term growth and the slowdown in 1996, the current economic projections for 1997 through 1999 are little different from those CBO made last August.

The Forecast for 1995 and 1996

The robust growth that the U.S. economy experienced in 1994 is likely to continue through the first part of 1995 but will fade by the end of the year. The 4.0 percent increase in real output (on a fourth-quarter-to-fourth-quarter basis) and the creation of over 3 million new jobs in 1994 were achieved without an increase in inflation, but that performance is not likely to be repeated in 1995 (see Table 1). Because the economy is already operating close to its potential, it cannot persistently expand faster

than the growth of potential output--estimated at 2.4 percent a year by CBO--without triggering modestly higher inflation.

The Federal Reserve, which is determined to avoid any significant increase in inflation, raised the federal funds rate by 250 basis points (2.5 percentage points) in 1994 and is likely to further boost short-term interest rates in 1995. CBO forecasts that 90-day Treasury bill rates will average 6.2 percent in 1995--up from 3.2 percent in the first quarter of 1994. Rates for 10-year Treasury notes are expected to increase more modestly. The high rates of business investment and personal consumption of durable goods that drove the economy forward in 1994 apparently have not yet declined and will keep growth strong in the first part of 1995. However, by 1996, the cumulative effect of past and future hikes in interest rates should begin to bring the economy back in line with potential output. As a result, CBO expects that growth of real GDP will slow to 1.9 percent in 1996.

Unemployment will remain low in 1995--it is forecast to average 5.5 percent, compared with 6.1 percent in 1994--but will climb to 5.7 percent in 1996. Even at 1996's slightly higher level, unemployment will be below CBO's estimate of 6.0 percent for the nonaccelerating inflation rate of unemployment (NAIRU). A sustained unemployment rate below the NAIRU indicates a future increase in wage inflation. With unemployment below the NAIRU and GDP exceeding potential output, inflation is expected to rise in 1995 and 1996. Because the economy has not become too

overheated and is expected to cool down later this year, the forecast upswing in the consumer price index for all urban consumers (CPI-U) is modest--from 2.7 percent in 1994 to 3.2 percent in 1995 and 3.4 percent in 1996 (see Table 1).

CBO's forecast assumes that the recent and anticipated future increases in short-term interest rates engineered by the Federal Reserve will restrain the economy to an appropriate degree. If the continuing strong growth that CBO foresees in early 1995 does not take place--if the economy has already started to cool off--the expected additional monetary tightening will slow growth sooner and more sharply than anticipated. Alternatively, if the economy proves stronger and more resistant than expected to the anticipated increases in interest rates and it surges well above potential output, the Federal Reserve will probably respond with even higher interest rates to combat the risk of inflation. That stronger-than-expected growth and the Federal Reserve's response to it could usher in a cycle of boom and bust for the economy.

Some economists argue that potential output may be greater than CBO estimates, in which case the economy could grow at its current rate for some time without triggering higher inflation. The Federal Reserve, however, is unlikely to allow such growth unless the evidence for a shift in potential output is more compelling than it currently is.

Projections for 1997 Through 2000

CBO attempts to forecast the cyclical fluctuations in the economy only for the next two years. Beyond 1996, its projections are based on trends in fundamental factors that determine the potential growth of the economy, including growth in the labor force, productivity, and national saving.

CBO's projections follow a path that has the gap between GDP and potential GDP reaching its historical average level--with GDP 0.6 percent below potential--at the end of the projection period in 2000. Because CBO estimates that the level of GDP will exceed potential output in 1996, the average annual real growth projected for 1997 through 2000 is slightly below the estimated 2.4 percent rate of growth of potential output (see Table 2). Unemployment is expected to increase slightly to 6.0 percent, the estimated level of the NAIRU. Projected consumer price increases are assumed to average 3.4 percent a year over the period, with projected interest rates declining from the levels associated with efforts to slow the economy in 1995 and 1996.

THE BUDGET OUTLOOK

Although CBO now projects that the deficits for fiscal years 1995 through 1999 will be almost \$25 billion a year higher, on average, than it anticipated last August, the fundamental budget outlook is not very different from the one CBO projected then. Moreover, there has been no substantial change in CBO's deficit projections since its report in September 1993, which for the first time reflected the more than \$400 billion in deficit reduction enacted in the Omnibus Budget Reconciliation Act of 1993 (see Figure 2). The deficit is still expected to fall in 1995 to its lowest level since 1989 and its lowest point as a percentage of GDP since 1979. As was also the case in August, the deficit is projected to begin rising again in 1996. CBO's extended budget projections show that trend continuing through 2005 if spending for discretionary programs increases at the rate of inflation after 1998. After 2002, currently projected deficits are slightly lower than the deficits forecast in August.

The Outlook for the Deficit

Since 1992's record-high shortfall of \$290 billion, the deficit has declined to \$255 billion (4.0 percent of GDP) in 1993 and \$203 billion (3.1 percent of GDP) in 1994. (Although a record in dollar terms, the 1992 deficit as a percentage of GDP was far short--at 4.9 percent--of even a postwar record.) CBO projects that the deficit will

decline for a third straight year to \$176 billion (2.5 percent of GDP) in 1995 (see Table 3). That gratifying trend is expected to end the next year, however, with the deficit climbing under current laws to \$207 billion (2.8 percent of GDP) in 1996 and \$224 billion in 1997 (2.9 percent of GDP) before leveling off in 1998.

The standardized-employment deficit, which is an estimate of the deficit that would occur if the economy was operating at its potential, is of interest because it is a measure of the fiscal posture of the federal budget without the cyclical effects of the economy. When the economy is operating below potential, the deficit swells as a result of reductions in revenues and increased spending for programs such as unemployment insurance. When the economy is operating above potential, revenues are increased and spending is lower. Because in CBO's forecast the economy will be operating close to potential throughout the 1995-2000 period, the projected standardized-employment deficits differ little from the projected total deficits. Despite that, a look at the standardized-employment deficit as a percentage of potential GDP is still illuminating. That measure varies only slightly from year to year during the 1994-1998 period, which makes it clear that the fiscal stance of the budget changes hardly at all during that time.

CBO's baseline projections for mandatory spending programs and taxes represent the outlays and revenues that will result if no changes are made in the laws governing those parts of the budget. The projections for discretionary spending

(spending controlled by annual appropriations) assume compliance with the discretionary spending limits for 1996 through 1998 established for general-purpose appropriations in the Balanced Budget and Emergency Deficit Control Act of 1985 and for specific anticrime appropriations in the Violent Crime Control and Law Enforcement Act of 1994. Because no level of discretionary spending is set by law for the years after 1998, CBO makes two different projections of the deficit for 1999 and later years. In one projection, discretionary spending grows at the rate of inflation; the purchasing power of the appropriations is thus held constant at the 1998 level. In the other, discretionary spending is frozen at the 1998 dollar level.

In the baseline projections with discretionary spending adjusted for inflation after 1998, the deficit resumes its upward path after the pause in 1998. By 2000, the last year of CBO's regular projections, the deficit of \$284 billion is almost back to the record level of 1992 (although at 3.1 percent, it is well below the 1992 deficit as a percentage of GDP). CBO's extended projections show deficits that continue to climb after 2000, reaching \$421 billion (3.6 percent of GDP) in 2005. The mounting deficits continue to be fueled primarily by increases in Medicaid and Medicare, even though projected costs for those programs are somewhat lower than CBO had estimated last August. All spending other than that for Medicaid and Medicare is projected to grow at an average rate of about 5 percent a year between 1998 and 2005, slightly slower than the rise in revenues. Projected spending for the two big

federal health programs, however, increases at an average rate of almost 10 percent a year after 1998.

In the baseline projections without inflation adjustments for discretionary spending after 1998, deficits level off at around \$240 billion a year from 1999 through 2005. (The projected deficit of \$242 billion for 2005 is equal to 2.1 percent of GDP.) Freezing discretionary appropriations at the 1998 dollar level through 2005 would result in funding for discretionary programs in 2005 that had about 27 percent less purchasing power than the 1995 appropriations. If total discretionary spending was frozen at the nominal 1998 level but defense spending was preserved at the 1995 funding level adjusted for inflation, the money available for all other discretionary programs in 2005 would have less than half the purchasing power of the 1995 appropriations for those programs.

All mandatory spending is the same in both baselines, except that interest payments reflect the lower deficits and debt in the version that does not adjust discretionary spending for inflation after 1998.

Changes in the Projections

The deficits that CBO currently projects for 1995 through 1999 are almost \$25 billion a year higher, on average, than those projected last August (see Table 4). Yet despite those increases, there has been no fundamental change in the deficit outlook. In fact, by 2003, the deficits in CBO's current extended projections are slightly lower than the deficits CBO projected in August.

Legislation enacted since then has had very little effect on the deficit outlook. The two most significant laws were an act making major changes in the federal crop insurance program in hopes of avoiding future ad hoc disaster assistance to farmers and an act implementing the Uruguay Round of the General Agreement on Tariffs and Trade (GATT). The crop insurance legislation increased estimates of the deficit by almost \$1 billion a year. Because CBO's baseline projections were made on the basis of current law, they did not include any spending that might result from the enactment of future ad hoc disaster bills. Therefore, reducing the likelihood of such legislation did not produce savings that could offset the higher spending for crop insurance. The GATT implementing legislation added almost \$3 billion to deficits over the 1995-1999 period because losses in revenues from lower tariffs were not completely offset by other revenue increases and spending cuts.

Changes in the economic forecast since August have had a greater effect on deficit projections than did legislation. Those changes have pushed down projected revenues by \$9 billion in 1996 and \$8 billion in 1997, largely because of lower wage and salary income than had been forecast in August. More significantly, the higher interest rates in the new forecast have driven up projected federal interest payments by more than \$15 billion a year, on average, in 1996 through 1999.

Taken altogether, technical reestimates--those changes that cannot be attributed to legislation or revisions in the economic forecast--have had little impact on projections of the deficit. But looking only at the total effect masks some significant changes. Projected Medicaid spending is lower in every year--by as much as \$13 billion in 1999--than was estimated in August, reflecting actual 1994 outlays that were lower than expected and evidence that the rapid growth in that program has slowed. Medicare expenditures are down only slightly over the 1995-1999 period, but CBO's extended forecasts have significantly lower spending for Medicare as well as Medicaid in the years after 2000. The Medicaid reductions in 1995 through 2000, however, are more than offset by technical reestimates that bring down projected revenues to reflect smaller-than-anticipated tax collections in 1994 and increased spending for a variety of programs other than Medicare and Medicaid.

ILLUSTRATIVE PATH TO A BALANCED BUDGET

A constitutional amendment requiring a balanced federal budget will be considered during the early days of the 104th Congress. If the Congress adopts such an amendment this year and three-quarters of the state legislatures ratify it over the next few years, the requirement could apply to the budget for fiscal year 2002. If the budget is to be balanced by 2002, it is important that the Congress and the President begin immediately to put into effect policies that will achieve that goal. According to CBO's latest projections of a baseline that adjusts discretionary spending for inflation after 1998, some combination of spending cuts and tax increases totaling \$322 billion in 2002 would be needed to eliminate the deficit in that year. The amounts of deficit reduction called for in the years preceding 2002 depend on both the exact policies adopted and when the process is begun.

For illustrative purposes, CBO has laid out one of many possible paths to a balanced budget in 2002 (see Table 5). Starting from a baseline that assumes that discretionary spending is adjusted for inflation after 1998, that path first shows the savings that would be achieved by freezing discretionary spending through 2002 at the dollar level of the 1998 cap. Such a freeze, along with the resulting debt-service effects, would produce \$89 billion of the required savings of \$322 billion in 2002. Under the freeze policy, the buying power of total discretionary appropriations in 2002 would be approximately 20 percent less than in 1995.

CBO also built into its illustrative path a possible course of savings from further policy changes. The amounts of those savings are not based on the adoption of any particular set of policies; they do assume, however, that policy changes are phased in between 1996 and 1999 in a pattern that is similar to the changes in mandatory spending enacted in the last two major efforts at deficit reduction in 1990 and 1993. After 1999, the assumed savings increase at the baseline rate of growth for entitlement and other mandatory spending, excluding Social Security--implying that the cuts implemented in earlier years have a permanent effect but no additional policy changes have been made. If those savings were achieved entirely out of entitlement and other mandatory programs (excluding Social Security), they would represent about a 20 percent reduction from current-policy levels for those programs.

Over the entire 1996-2002 period, the savings in CBO's illustrative path that result directly from policy changes total more than \$1 trillion (in relation to a baseline that adjusts discretionary spending for inflation after 1998). When the resulting savings in debt-service payments are included, the total exceeds \$1.2 trillion. As noted, this path and the resulting \$1.2 trillion in savings are illustrative only; the actual amount of cumulative deficit reduction over the 1996-2002 period will depend on the timing and exact nature of the policies enacted to achieve balance in 2002.

The required savings from policy changes would be smaller and the debt-service savings greater if, as CBO anticipates, ongoing deficit reduction efforts

over this period result in lower interest rates. CBO believes that by 2000, interest rates could be as much as 1 percentage point lower than it currently forecasts if spending cuts and tax increases that would lead to a balanced budget have been enacted and the financial markets are convinced that policymakers will maintain those policies. CBO estimates that such a drop in interest rates would lower projected federal interest payments--and the amount of savings from policy changes needed to balance the budget--by almost \$140 billion over the 1996-2002 period.

CONCLUSION

CBO's most recent economic and budget projections underscore the challenge facing policymakers who may have to enact the spending cuts or tax increases needed to balance the budget by 2002. Although the long-term budget outlook is no worse now than it was last August, the new projections emphasize that the deficit can be eliminated only through major changes in current policies.

Figure 1.
Comparison of CBO Projections With and Without Discretionary Inflation After 1998 (By fiscal year)



SOURCE: Congressional Budget Office

NOTE: Caps on discretionary spending are set by law through 1998. Measures of the deficit "with discretionary inflation" assume that discretionary spending grows at the rate of inflation after 1998. Measures of the deficit "without discretionary inflation" assume that discretionary spending remains frozen in dollar terms at the level of the 1998 caps.

Figure 2.
Comparison of CBO Deficit Projections (By fiscal year)



SOURCE: Congressional Budget Office

NOTE: The projections assume that discretionary spending rises with inflation after the caps expire in 1998.

Table 1.
Comparison of Forecasts for 1995 and 1996

	Actual		Forecast	
	1993	1994	1995	1996
Fourth Quarter to Fourth Quarter (Percentage change)				
Nominal GDP				
CBO	5.0	6.3	5.3	4.7
<i>Blue Chip</i>	5.0	6.3	5.7	5.4
Real GDP ^a				
CBO	3.1	4.0	2.5	1.9
<i>Blue Chip</i>	3.1	4.0	2.5	2.2
Implicit GDP Deflator				
CBO	1.8	2.3	2.8	2.8
<i>Blue Chip</i>	1.8	2.3	3.1	3.2
Consumer Price Index ^b				
CBO	2.7	2.7	3.2	3.4
<i>Blue Chip</i>	2.7	2.7	3.5	3.5
Calendar Year Averages (Percent)				
Civilian Unemployment Rate				
CBO	6.8	6.1	5.5	5.7
<i>Blue Chip</i>	6.8	6.1	5.6	5.7
Three-Month Treasury Bill Rate				
CBO	3.0	4.2	6.2	5.7
<i>Blue Chip</i>	3.0	4.2	6.2	5.1
Ten-Year Treasury Note Rate				
CBO	5.9	7.1	7.7	7.0
<i>Blue Chip</i> ^c	5.9	7.1	7.9	7.6

SOURCES: Congressional Budget Office, Eggert Economic Enterprises, Inc., *Blue Chip Economic Indicators* (January 10, 1995); Department of Commerce, Bureau of Economic Analysis

NOTE: The *Blue Chip* forecasts are based on a survey of 50 private forecasters.

a. Based on constant 1987 dollars.

b. The consumer price index for all urban consumers (CPI-U).

c. *Blue Chip* does not project a 10-year note rate. The values shown here for the 10-year note rate are based on the *Blue Chip* projections of the Aaa bond rate, adjusted by CBO to reflect the estimated spread between Aaa bonds and 10-year Treasury notes.

Table 2.
The Economic Forecast and Projections (By calendar year)

	Actual 1994	Forecast		Projected			
		1995	1996	1997	1998	1999	2000
Nominal GDP (Billions of dollars)	6,737	7,127	7,456	7,847	8,256	8,680	9,128
Real GDP (Billions of 1987 dollars)	5,342	5,505	5,602	5,736	5,870	6,004	6,141
Real GDP (Percentage change)	4.0	3.1	1.8	2.4	2.3	2.3	2.3
Implicit GDP Deflator (Percentage change)	2.1	2.6	2.8	2.8	2.8	2.8	2.8
CPI-U (Percentage change) ^a	2.6	3.1	3.4	3.4	3.4	3.4	3.4
Unemployment Rate (Percent)	6.1	5.5	5.7	5.8	5.9	6.0	6.0
Three-Month Treasury Bill Rate (Percent)	4.2	6.2	5.7	5.3	5.1	5.1	5.1
Ten-Year Treasury Note Rate (Percent)	7.1	7.7	7.0	6.7	6.7	6.7	6.7

SOURCE: Congressional Budget Office

a. CPI-U is the consumer price index for all urban consumers

Table 3.
CBO Deficit Projections (By fiscal year)

	1994	1995	1996	1997	1998	1999	2000
In Billions of Dollars							
Baseline Total Deficit							
With discretionary inflation after 1998	203	176	207	224	222	253	284
Without discretionary inflation after 1998	203	176	207	224	222	234	243
Standardized-Employment Deficit ^a							
With discretionary inflation after 1998	187	200	216	223	221	247	273
Without discretionary inflation after 1998	187	200	216	223	221	228	233
As a Percentage of GDP							
Baseline Total Deficit							
With discretionary inflation after 1998	3.1	2.5	2.8	2.9	2.7	3.0	3.1
Without discretionary inflation after 1998	3.1	2.5	2.8	2.9	2.7	2.7	2.7
Standardized-Employment Deficit ^b							
With discretionary inflation after 1998	2.8	2.8	2.9	2.9	2.7	2.9	3.0
Without discretionary inflation after 1998	2.8	2.8	2.9	2.9	2.7	2.6	2.6

SOURCE: Congressional Budget Office

NOTE: Caps on discretionary spending are set by law through 1998. Measures of the deficit "with discretionary inflation" assume that discretionary spending grows at the rate of inflation after 1998. Measures of the deficit "without discretionary inflation" assume that discretionary spending remains frozen in dollar terms at the level of the 1998 caps.

a. Excludes the cyclical deficit and spending for deposit insurance.

b. Shown as a percentage of potential gross domestic product.

Table 4.
Changes in CBO Deficit Projections (By fiscal year, in billions of dollars)

	1995	1996	1997	1998	1999
August 1994 Baseline Total Deficit with Discretionary Inflation After 1998	162	176	193	197	231
Changes					
Policy changes	2	2	2	3	3
Economic assumptions					
Revenues ^a	2	9	8	3	b
Net interest	8	16	17	15	15
Other outlays	<u>b</u>	<u>b</u>	<u>1</u>	<u>2</u>	<u>2</u>
Subtotal	10	25	27	20	17
Technical reestimates					
Revenues ^a	6	5	6	9	11
Deposit insurance ^c	1	3	b	b	1
Medicaid and Medicare	-7	-6	-8	-11	-15
Net interest ^c	b	-1	b	b	1
Other outlays	<u>b</u>	<u>5</u>	<u>4</u>	<u>3</u>	<u>5</u>
Subtotal	1	5	2	2	2
Total	13	31	31	26	22
January 1995 Baseline Total Deficit with Discretionary Inflation After 1998	176	207	224	222	253

SOURCE: Congressional Budget Office

NOTE: Caps on discretionary spending are set by law through 1998. Measures of the deficit "with discretionary inflation" assume that discretionary spending grows at the rate of inflation after 1998.

a Revenue reductions are shown with a positive sign because they increase the deficit.

b Less than \$500 million.

c Excludes changes in interest paid by deposit insurance agencies to the Treasury. These interest payments are intrabudgetary and do not affect the deficit.

Table 5.
Illustrative Deficit Reduction Path (By fiscal year, in billions of dollars)

	1995	1996	1997	1998	1999	2000	2001	2002	1996- 2002
CBO January Baseline Deficit with Discretionary Inflation After 1998	176	207	224	222	253	284	297	322	n.a.
Freeze Discretionary Outlays After 1998									
Discretionary reduction	0	0	0	0	-19	-38	-58	-78	-193
Debt service	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>-1</u>	<u>-2</u>	<u>-6</u>	<u>-10</u>	<u>-19</u>
Total Deficit Reduction	0	0	0	0	-19	-40	-63	-89	-212
CBO January Baseline Deficit Without Discretionary Inflation After 1998	176	207	224	222	234	243	234	234	n.a.
Additional Deficit Reduction									
Policy changes ^a	0	-32	-65	-97	-145	-156	-168	-180	-843
Debt service	<u>0</u>	<u>-1</u>	<u>-4</u>	<u>-10</u>	<u>-18</u>	<u>-28</u>	<u>-40</u>	<u>-54</u>	<u>-156</u>
Total Deficit Reduction	0	-33	-69	-106	-163	-184	-208	-234	-998
Resulting Deficit	176	174	155	116	71	59	26	b	n.a.
Total Change from Baseline Deficit with Discretionary Inflation After 1998									
Policy changes	0	-32	-65	-97	-164	-194	-225	-259	-1,035
Debt service	<u>0</u>	<u>-1</u>	<u>-4</u>	<u>-10</u>	<u>-19</u>	<u>-31</u>	<u>-46</u>	<u>-64</u>	<u>-175</u>
Total Deficit Reduction	0	-33	-69	-106	-182	-225	-271	-322	-1,210

SOURCE: Congressional Budget Office.

NOTES: Caps on discretionary spending are set by law through 1998. Measures of the deficit "with discretionary inflation" assume that discretionary spending grows at the rate of inflation after 1998. Measures of the deficit "without discretionary inflation" assume that discretionary spending remains frozen in dollar terms at the level of the 1998 caps.

n.a. = not applicable

a. These changes represent only one of a large number of possible paths that would lead to a balanced budget. The exact path depends on when deficit reduction begins and the specific policies adopted by the Congress and the President. The path illustrated in this table is not based on any specific policy assumptions but does assume that policies are fully phased in by 1999.

b. Surplus of less than \$500 million.

Chairman KASICH. Thank you, Doctor.

Let me just ask you to restate one more time. What was your bottom line you said, if we got to a balanced budget? You listed several things there. Could you repeat those again? You said that if we got there, we could anticipate these kinds of things.

Mr. REISCHAUER. The benefits?

Chairman KASICH. Yes, the benefits, right.

Mr. REISCHAUER. We would expect productivity to increase, living standards to rise, our dependence on foreigners for investment in this country to be reduced, and our debt-to-GDP ratio to begin to fall again, as it did in most years from World War II to the mid-1970's.

Chairman KASICH. Conversely, what would happen? It was interesting. You said somewhere that if we do X, we will only have a deficit of \$221 billion. You need to get outside the beltway, doctor.

Mr. REISCHAUER. That would be 2.1 percent of GDP, which is considerably lower than what we have experienced for a long time.

Chairman KASICH. Let me tell you—

Mr. REISCHAUER. That is real money. I am not pretending that it is not.

Chairman KASICH. The emphasis was like it will only be \$221 billion. If we went to one of these town meetings and said, you know, we will only be at \$221 billion, the oil would be boiling right outside the building.

I want to say, conversely, the benefits of the balanced budget amendment will—and there is one thing you said in there that I particularly like, the living standards would rise. What is the converse side, if we keep on the path we are on? What would the country look like?

Mr. REISCHAUER. If we keep on the path we are on, I do not think living standards are going to fall. If we balance the budget, if we increase national savings, living standards will rise more than they would otherwise. We have had increases in living standards, but they have been very minimal and that has led to a lot of dissatisfaction among the American people over the last 20 years.

With substantial deficit reduction in the long run—and we are talking about two, three, four decades in the future, we are not talking about instant gratification, we are talking about intergenerational gratification—the living standards of our children and grandchildren will be higher than they otherwise would be.

Chairman KASICH. I have been very interested with some of the comments about the fact of is the middle-class not achieving what it used to achieve, are we having these growing gaps. What you would argue then is we really could move to balance the budget, for folks who have been struggling to try to have a better life, we would anticipate that the next generation would benefit from the standpoint that some of the problems that we have been experiencing lately would be mitigated, we would begin to see folks who have been struggling to have a better life?

Mr. REISCHAUER. I am not sure anybody could tell you that balancing the budget or increasing national saving will reduce income disparities, but I believe you and I would agree that that is not what is concerning Americans. What is concerning them is their

own individual circumstances, not so much how others might be living. One would expect that the whole level of living standards would rise across the board.

Chairman KASICH. One other question about entitlements. Do you think it possible to enact good policy that literally would be fair to Americans in these areas of entitlement changes, and yet still have some major impacts on what happens with this deficit and balancing the budget?

In other words, let us just take Medicare for a second. If we decided that we were going to have options that moved people away from fee-for-service medicine, do you think that is a good policy option that would result in savings?

Mr. REISCHAUER. I think you could design options that would have those positive impacts. Right now, of course, Medicare participants and beneficiaries have an option of joining HMO's, but the research that has been done suggests that that has not led to any substantial saving, in large measure because the reimbursements that we provide to those HMO's are high in relation to the expected expenditures of the individuals who happen to choose Medicare HMO's. In addition, there is an option that you can bail out of your HMO with a month's notice.

Unlike most health insurance, which locks you in for a year and then has an open enrollment period, it is possible for a participant in a Medicare HMO who needs large medical services to opt out and go back to fee-for-service. But I think you could design a system that would lead to savings, although there is not a lot of research that shows the potential for managed care lowering the costs of care for the elderly. Most of the research has obviously been focused on the working-age population.

Chairman KASICH. But when you have a working-age population where you are essentially getting about half the growth that you are getting in your Medicare program, that would suggest that policies they are pursuing in the private sector are clearly working to impact cost, and obviously they have got to strain and work hard to maintain quality. We obviously are following a system that is not working very well. Is that not true?

Mr. REISCHAUER. That is true, and we see in some places, such as certain counties in Oregon, large fractions of the Medicare population going into HMO's, because they have grown up in the system. They have worked all their lives in an environment in which they have received their medical services through an HMO. When they turn 65, they obviously want to maintain their existing relationships, and I think it is a fertile area for research to see exactly how much saving is possible.

Chairman KASICH. In other words, there actually could be senior citizens who move from their current HMO environment into the fee-for-service Medicare who would say why has the government taken away the system that I really would liked to have been in?

Mr. REISCHAUER. That is possible, but they do have the option of staying in HMO's; not every HMO, because there are only certain ones that are approved by Medicare.

Chairman KASICH. Mr. Sabo?

Mr. SABO. The growth that has occurred in the economy, how much of that has been consumer spending versus increases in basic plant and equipment expenditures in this country?

Mr. REISCHAUER. Why don't I provide that for the record. Plant and equipment spending has been very strong, but we have to remember that this is an economy that is driven largely by consumer spending, which makes up almost two-thirds of total demand.

[The information referred to follows:]

The economic growth since the end of the last recession in 1991 has been driven by investment spending; consumption has kept pace with real growth but it has not been the stimulus for growth. Between 1991 and 1994, the share of investment in real GDP has increased from 14.1 percent to 16.9 percent. The share of expenditures for personal consumption, however, has remained virtually constant at 67 percent of GDP.

This pattern is typical for periods of economic expansion. Investment usually rebounds sharply in the early years of recovery, whereas consumption tends to grow in line with the growth of the overall economy.

Mr. SABO. But plant and equipment spending has been very strong relatively. Is that not accurate?

Mr. REISCHAUER. Yes.

Mr. SABO. While I talked in my opening statement about "rosy scenarios," your assessment is a fairly pessimistic scenario for 1996. You have growth being at 4 percent in 1994, 3.1 percent in 1995, dropping to 1.8 percent in 1996. I am curious, particularly with plant and equipment fairly strong. What leads you to that?

Mr. REISCHAUER. Well, CBO believes that the economy is at full capacity or even a little above full capacity, that the Federal Reserve Board is concerned that inflationary pressures will begin to mount if the economy continues growing at 4 percent or 3.5 percent, and that it will take action to slow the economy down closer to what is called its potential growth path, which is a function of how much new labor is coming onto the market and how much productivity is increasing. And most economists think that potential growth is something on the order of 2.5 percent a year. So the Federal Reserve would like to bring the growth rate down closer to 2.5 percent. The Federal Reserve obviously does not have a set of dials with which it can fine tune this kind of adjustment. It is likely to cause the economy to slow down below 2.5 percent, and that is what we have in our forecast. As I said, it is a very consensus type of forecast.

Mr. SABO. Over the last 15 or 20 years, with the increase of productivity in our society, where has the income gained from that productivity gone?

Mr. REISCHAUER. If you are asking me what has happened to the income distribution, disproportionate amounts of the total gain in productivity have gone to the most educated, most skilled, highest income portions of our economy. The phenomenon has occurred throughout the world, though. It has to do with the way technology has been evolving and the increased importance on brain power. In effect mental powers are being rewarded much more than labor or physical power.

Mr. SABO. What brings the economists, those at the Federal Reserve or others, to the conclusion that there is this creeping shortage of labor supply? Let me use Minnesota as an example. Our un-

employment rate is 3.5 percent statewide, which would send the Federal Reserve ballistic.

On the other hand, a recent study concluded that for a livable wage, simply a livable wage in our urban area, you needed minimum income of a little bit over \$20,000, and in non-metropolitan areas slightly under \$20,000. The analysis showed that over half the jobs in our State had income less than a livable wage. For applications for any job that paid a livable wage in our State, the number of applicants per job was something like six or seven per one—I think it may even have been higher—which indicated that while there are a large number of jobs available, they are not ones that pay a livable wage. When you get to jobs that pay a livable wage, the number of people applying was incredibly high.

I think this view of looking at the traditional statistics on unemployment and people available in the labor market is an old method and does not reflect the reality of people out in the labor market today looking for jobs that pay a very bare essential livable wage. And the supply of people well trained and qualified to do those jobs is incredibly high.

So I have serious doubts about the analyses of all the traditional economists about what is happening with the labor force and the response of the Federal Reserve.

Mr. REISCHAUER. Do you want me to comment on that?

Mr. SABO. Yes.

Mr. REISCHAUER. That is what I was afraid of. [Laughter.]

One reason the Federal Reserve does not go ballistic over the 3.5 percent unemployment rate in Minnesota is that southern California or California as a whole has a much higher unemployment rate and we are a single market in which goods and services and money flows from State to State. So a very tight labor market in Minnesota or North Carolina does not have inflationary pressures.

Mr. SABO. I guess my point is I do not think the labor market in Minnesota is tight.

Mr. REISCHAUER. What you have described is a situation in which a great many people in Minnesota would like to have jobs that paid more than those that they have, not necessarily that there are additional people who are outside of the labor force who will be attracted into it if more jobs were available. I think your statement is quite accurate.

There are many Americans who are working at jobs that in a sense are beneath them. They could be performing more complicated, higher-paying jobs, but those jobs are not always available and they will continue to search for them and compete for them. But that competition, remember, is going to mean that those jobs do not have the wage gains that one might otherwise expect, because there is a pool of individuals willing to work at whatever the prevailing wage is for that more complex job, and markets will work this out over time. One should see an increase in wages for the low-skilled jobs in relation to the better jobs that many people are competing for.

Mr. SABO. Thank you.

Chairman KASICH. Mr. Allard?

Mr. ALLARD. Thank you, Mr. Chairman.

Dr. Reischauer, I am committed to a balanced budget amendment. I also feel very strongly that in order to get there, we need to cut spending as opposed to raising taxes. I am also committed to reducing taxes. So your comments on tax increases obviously generate my interest.

What I have here is a chart put together with January 1995 CBO figures. It has the average projected rate of growth at 5.3 percent, and what will happen if that goes out to 2002. I also have a line here that shows what happens with the Contract With America, which has tax cuts in it, as well as some effort there to hold down spending. But even at that, there is a continued rate of growth in revenue to the Federal Government.

If we assume a 2-percent average increase in spending in outlays every year, we have eliminated the deficit in 2001–2002. Now, my question is this: If we limit the rate of growth of spending of the general fund to 2 percent, what kind of economic impact do you see out there?

Mr. REISCHAUER. The economic impact should not be much different from the one that I described in my testimony.

Mr. ALLARD. What are the benefits first?

Mr. REISCHAUER. The benefits are likely to be realized only after 2002. No one is going to say that the process of getting from here to there is not going to be painful. It is like going on a diet or getting in shape.

Mr. ALLARD. But I am looking for an economic analysis. If we hold the rate of spending increase to 2 percent, what are the benefits that would accrue, and what are the downsides? If you could give me an analysis of what you see as the benefits and then what you would see as possible downsides.

Mr. REISCHAUER. The benefits in the long run will be that productivity will increase, standards of living will be higher than they otherwise would have been, and that we will not depend on foreigners as much for investment as we have over the past several decades. Those benefits are likely to be realized one, two, or three decades from now. That does not mean that we should not engage in this form of policy.

The problems come from the fact that it will be very hard to restrain spending to a 2-percent level without fundamentally changing the structure of current Federal programs. Now, that might be desirable and you might say that is a good thing to do. But remember we have Medicare and Medicaid perking along at roughly 10 percent a year, and to bring them down to 2 percent means that the type of medical assistance that we are providing to the elderly and the poor will be fundamentally different by the year 2002. If you want to maintain defense spending at the current level—

Mr. ALLARD. We know how to get there. We are going to get there and we are going to maintain it at 2 percent. What kind of effect is that going to have on growth? If we limit government spending to a rate of increase of 2 percent, what effect will it have on growth between now and 2002?

Mr. REISCHAUER. Let me answer this in stages. As I said before, a path like that is going to impose fiscal restraint of about 0.4 percent of GDP on the economy. Old-fashioned Keynesian-type restraint will be imposed on the economy.

Mr. ALLARD. So economic growth would be less?

Mr. REISCHAUER. That would slow down the economy, but offsetting that, as I said in my statement, will be the fact that interest rates will be lower for a variety of reasons, and that will stimulate investment, our exchange rate will be lower and that will stimulate exports. Probably, if there are no substantial external shocks, the economic growth over the 1995-2002 period would not be substantially different than it otherwise would be, meaning that if we kept on our path of profligacy. In a sense that is the good news. It would not necessarily be a big disaster.

Now, there could be——

Mr. ALLARD. let me catch you right here, because my time is running out. There might be some economic growth slowdown, but is the capital gains tax cut going to have an impact on that? I would think that would be important.

Chairman KASICH. I am not going to cut the gentleman off, but remember we have got a lot of people.

Answer Mr. Allard's question, Doctor. Make sure you answer it right, too. [Laughter.]

Mr. REISCHAUER. You have fed something else into this equation that we have not looked at specifically, which is a set of changes in our Tax Code, some of which would stimulate investment, some of which might encourage saving, and some of which, like a tax credit or children, would have negative impacts on the economy, and CBO has not done an analysis to sort through all of that.

I would suggest to you that I would be very surprised if all of these changes taken together markedly changed growth expectations over the next 7-year period.

Mr. ALLARD. Thank you, Mr. Chairman.

Chairman KASICH. I want to recognize and also congratulate the gentleman from Texas, Mr. Stenholm, who labored for years to have success with his legislation on the balanced budget amendment. The gentleman is clearly to be commended and congratulated, and we appreciate it.

The gentleman from Texas, Mr. Stenholm.

Mr. STENHOLM. Thank you, Mr. Chairman.

Let me put a basic premise to my question by saying first off thank you for giving a projection to the year 2002 of what it is going to take to get there, so that all of us, the majority on this committee who are dedicated to bringing about a balanced budget by the year 2002 have got an idea what it is going to take.

Also, let me state my basic premise, based on a lot of rhetoric, that Social Security is off the table, Medicare is off the table, and increasing taxes are definitely off the table. That is my basic premise.

I also believe in my simple math that a 1 percent increase in interest rates will increase our deficit \$47 billion a year. If you assume \$4.7 trillion in debt and 1 percent just for assumption, that is \$47 billion.

Right now, the Federal Reserve is increasing interest rates in order to cool down the economy. Some folks disagree with that. I would like to be included among those of saying that is not helpful, but I understand what they are trying to do.

Now, having said all of that as the basic premise, my question is, given the difficulty of the task—and the 2 percent example that my colleague from Colorado used, I can support that, and I am prepared to do all of those things necessary to get that. But as you rightfully pointed out, that makes some very tough legislative decisions that the majority in the Congress have nowhere been close to doing as yet.

Now, my question is this: How in this scenario can we justify cutting taxes for any reason today, if we want to get to a balanced budget? Give me some positive reasons that you can think of why we should cut taxes in order to get to a balanced budget in the year 2002.

Mr. REISCHAUER. Let me say that reducing the deficit and reducing tax burdens are both desirable objectives, but they are objectives that are diametrically opposed to each other. They are in total conflict. If you place primacy on deficit reduction, it is very difficult to make a cogent argument for reducing taxes. You can rearrange taxes, while keeping the total amount of taxes the same, to encourage investment and saving and discourage consumption, and one could make an argument for that; we should put a heavier burden on consumption, we should reduce the taxes that we impose on labor or investment and place higher excise taxes or something like that. But I think it is impossible, if you believe on deficit reduction is of primary importance, to make an argument that says we should reduce taxes.

Let me go back one step. Given your premises, you are laying out an even tougher set of reductions than your colleague from Colorado. You said let us take Social Security and Medicare off the table and let us exclude interest, because there is nothing one can do about interest except lower the deficit. That will bring interest down, because rates and the amount of debt service you need will fall.

The revenues that we expect for the year 2002 are \$1.88 trillion. Spending right now totals \$1.531 trillion. That means that we are going to let spending grow to what revenues will be in 2002, we have \$349 billion that can be added to spending.

We expect Social Security to grow by \$148 billion, so that has eaten up a big chunk. CBO expects Medicare to grow by \$168 billion, and debt service—adjusting for the fact that we have a lower deficit because we balanced the budget—to grow by about \$50 billion. That has more than used up the \$349 billion that you had. It implies that everything else has to shrink in nominal terms, that there are fewer dollars available for everything else—civil service and military retirement, veterans programs, unemployment insurance—many things that I think you would regard as being off the table. In certain respects you really cannot make savings in things like unemployment compensation, because it is State money and it is State trust funds.

So you have laid out a task that is extremely difficult to accomplish, not impossible; but difficult.

Mr. HERGER. Would the gentleman yield?

Mr. STENHOLM. It is basically what I believe the game plan that the majority of us on this committee have set out for us, and it is a very difficult task, is all I would say.

Mr. HERGER. Would the gentleman yield?

Chairman KASICH. The gentleman's time has expired.

Just like the football game—congratulations, by the way, Steve Largent being enacted into the Hall of Fame this last weekend. How about a round of applause for him? [Applause.]

I still say he is too small and too slow. [Laughter.]

Anyway, we are keeping the time on the field now, because our clock is screwed up again. The gentleman from Michigan, Mr. Smith.

Mr. SMITH OF MICHIGAN. What I hear is probably we can be in the Hall of Fame, if we are able to keep the scenario and balance the budget by the year 2000 with the tax decreases. I would personally hope that Social Security and Medicare and everything else are on the table for the long run, because I see a very tough, maybe close to impossible solution without that.

But on tax decreases, with a little bit of pride in authorship of neutral cost recovery, give me your opinion. Will passage of neutral cost recovery for machinery and equipment depreciation increase economic activity and result in more and better jobs?

Mr. REISCHAUER. We have not yet examined that in detail, and I would withhold an answer. I think a lot depends on the detail here. There are changes in depreciation and investment incentives that can increase growth, although our history would suggest that the impacts are relatively small. This is true of almost everything in the economy. You can make changes that appear to be very significant policy changes, but the effects on the economy are relatively marginal.

Mr. SMITH OF MICHIGAN. Let me follow up on Mr. Sabo's question on the income gain from productivity. You indicated that it has tended to go to brain over brawn. What has happened over the last couple decades in terms of that gain to going to capital versus labor, whether the labor is brain or brawn? [Pause.]

Could I have a timeout, Mr. Chairman?

Chairman KASICH. The gentleman is down to his last time-out.

Mr. SMITH OF MICHIGAN. Well, let me rephrase the question.

Mr. REISCHAUER. I am getting more confused listening to the answer than listening to the question.

Mr. SMITH OF MICHIGAN. You know it is always a good answer to say "I don't know."

Mr. REISCHAUER. I thought it was obvious that I did not know. I did not think I had to admit it publicly, to go down in the hall of fame of the Budget Committee for not knowing. [Laughter.]

Mr. SMITH OF MICHIGAN. Is our return to capital in this country from productivity increases in general similar to the rest of the world? Are you familiar with that? I see somebody nodding their head. Has the purchasing power from earnings for middle-class Americans gone up or down in the last 30 years?

Mr. REISCHAUER. The real income of most of the population has gone up.

Mr. SMITH OF MICHIGAN. Help me understand why it is taking two people to work today, where one person in the family was working 30 years ago? Are you saying that is just higher expectations?

Mr. REISCHAUER. A lot of it is higher expectations.

Mr. SMITH OF MICHIGAN. I realize if two people in the family are working, there is more money coming in. But just for the purchasing power of one average middle-class working American, that purchasing power or neutralizing that dollar?

Mr. REISCHAUER. I think you are asking is whether real wages per worker working have risen, adjusted for the fact that hours have changed. The answer is yes, they have risen.

What we should be looking at is not necessarily the dollar value that people are paid for a 40-hour week, but their total compensation, and their total compensation includes fringe benefits. U.S. workers have received considerable increases in fringe benefits. By and large these are medical fringe benefits over the course of the last two decades.

People do not necessarily feel that they are better off, because their cash wages have not changed and they are saying to themselves, "I just have the same health insurance that I had 2 years ago or 5 years ago, but that health insurance is really very different." It is providing goods and services that were not dreamed of a decade ago.

Mr. SMITH OF MICHIGAN. Thank you.

Chairman KASICH. Ms. Meek?

Ms. MEEK. Thank you, Mr. Chairman.

As I listen and read your comments here and think of the assumptions upon which you have based most of your findings and from your experience, many of the people I represent do not reach many of the levels which you have in your presentation, particularly the unemployment rate and that kind of thing.

Of course, as I sit here over the years trying to see some light at the end of the tunnel in terms of the inflationary rate and in terms of the beautiful outlook that I see and read about, I just wonder how we will ever get to balancing the budget, when we have this great number of underclass people who are really still sort of like eating at the trough here, and whether or not we will be able to balance the budget over the years.

When I hear Mr. Stenholm talk, I have been trying over the years to believe in what he was saying and trying to subscribe to some of the things he is talking about. But I do not see how we are going to do it, with all the entitlement programs that we have going on, and it is not changing. When I read the forecasts here, I do not see where the revenues are going to come.

I am new to this committee, so it is good that I will be here to see how things evolve. I guess my comment is I am yet to understand how, with the deficit as it is and it will continue to rise by the year 2000, with economic conditions not really reaching down as far as perhaps they should, I do not see this real good bright forecast that a lot of members might see.

My comment is it will be a challenge to try to balance the budget by that time, because it is hard to get rid of all these people that are here that are pulling on us. I do not have a question. I just want you to see what my feelings are in the committee in terms of the dilemma that I see us in. I just do not see how, even with the forecast, I do not see where the revenue is coming from. Maybe it is there, and those of you who can make these rosy projections,

my point is we are not really at that rosy point in all the people that I serve.

Chairman KASICH. Thank you, Ms. Meek. I think maybe the point you are making—and it is always something that has troubled me—is when we say unemployment is 4 or 5 percent, you know, clearly it is better than any number higher than that. But when it is not zero, that means it is a total depression for somebody that does not have a job.

I think that part of our challenge on this committee—not just in this committee, but in this Congress—is to figure out how to better help people to help themselves, how to better deliver services to give people opportunities so that they can get out of the hardcore unemployed status and get jobs. I think it is our intention to try to breathe some new life into the way in which we have tried to do things for the last 20 years.

The gentleman from Michigan, Mr. Hoekstra?

Mr. HOEKSTRA. Thank you, Mr. Chairman.

Mr. Reischauer, I am looking at a chart on page 43, which I find fascinating, in the Economic and Budget Outlook for fiscal years 1996–2000. A question that I have been asking my staff and that I am trying to get a handle on is exactly why mandatory spending is increasing by the rates that it is projected to increase, the way I look at it almost 40 percent in that 5-year period. I assume that the majority of that would be a growth in caseloads, but what I see is that it is actually coming from a number of different areas. Maybe you could explain a few of those.

No. 1, there is concern that the cost of living numbers may be overstated, like in the year 2000 it is contributing \$80 billion out of the \$327 billion. Then you take a look at another item, the fourth item down, there are other increases in Medicaid and Medicare which is \$112 billion, and then another which is identified as Other which is \$9 billion. I came out of the business sector and I do not see in this table anywhere any description of perhaps any service improvement and product improvement that would actually enable us to reduce cost and improve service. Is that something we do not talk about in government?

Those are two questions. The first one is explain those three categories to me so I can understand them a little bit better. And do you factor any kind of cost savings or quality improvement into your numbers?

Mr. REISCHAUER. Fine. This is a table on page 43 of our Economic and Budget Report and it tries to allocate the increase in mandatory spending between 1996 and 2000 into various components, the first of which is growth in caseload. That means simply that there will be more people receiving Social Security in the year 2000 than in 1996, or more people receiving food stamps in 2000 than in 1996, and that accounts for about 20 percent of the total increase.

The second component is cost-of-living adjustments and it amounts to about 24 percent of the total increase. That is the automatic increase that is built into our current legislation. We increase SSI, Social Security, and various other benefits automatically once a year according to some increase in the price index, and there has been some discussion about whether the index commonly

used is an accurate measure of the increase in cost of living or might overstate it slightly. That is an issue for the Congress to debate.

The other large component of this, accounting for 34 percent of the total, is what is called other increases in Medicaid and Medicare, and those are a reflection of the fact that medical spending is rising because of precisely those factors cited in the second part of your question. Diagnostic procedures, techniques, and surgeries are becoming more complex and more expensive; they are new and improved. Unfortunately, more expensive treatments are available and they are being enjoyed by the nonaged population and the aged population, and that is a problem. Unless we can bring down the costs of such improvements in the general medical area, I think it would be unrealistic to assume you could do something particularly for the aged group.

The chairman mentioned that we could possibly restructure the Medicaid and Medicare programs to achieve some of the efficiencies that have been produced in the employed sector through managed care. That is certainly a possibility, although, as I said to him, there is not a great deal of evidence that would give us some kind of handle on the amount of savings that might be generated by efficiencies of that sort.

Chairman KASICH. I think I will give some latitude to the gentleman.

Mr. HOEKSTRA. The increases in Medicaid and Medicare, would you describe those as actually benefit improvements or product improvements to the beneficiaries? Are we expanding the scope of the programs because they are getting new services and benefits?

Mr. REISCHAUER. I think that in large measure that is the case. It could also be increases in inefficiency. One really does not know.

Mr. HOEKSTRA. Thank you.

Chairman KASICH. Mr. Olver?

Mr. OLVER. Thank you, Mr. Chairman.

I have to make one very brief comment, and it will be brief, because we really do not have much time here. We have been often told that Congress is out of touch with those outside the beltway. It must also be that economists is out of touch with those outside the beltway, too. There is a great disconnect between what I hear you saying and what I am hearing from people in my district.

Could we equate living standards with rise in family income, or is that not a correlation that one can depend upon?

Mr. REISCHAUER. I would say that it is a correlation. It is not a perfect measure of living standards. I think there is a lot else involved in living standards, such as—

Mr. OLVER. Could you provide for me at least what it is when you define living standards rising? What are the components of living standards rise and what percentage of the total 100 percent of living standard rise might be attributable to real income increase, and what might be to several other things that you—I will accept that there are other factors, but I would like to know what they are without your answering here and trying to give a percentage to it here.

Mr. REISCHAUER. I would not give you a percentage, but I would just say that in most of the use of the term in our book, it relates——

Mr. OLVER. Well, the analysis of components certainly ought to be able to put some sort of percentage relationship to what is involved.

Mr. REISCHAUER. There is no measurable item called living standards that people would generally agree to. I am using it——

Mr. OLVER. In using living standards, how would you define it?

Mr. REISCHAUER. I am using it almost exclusively in an economic sense, meaning real income levels.

Mr. OLVER. You have used it almost so the correlation with real income levels is very strong you said.

Mr. REISCHAUER. Right.

Mr. OLVER. That is good. Now, from the years 1945–1975, for instance, after the Second World War, would it be fair to say that living standards, real incomes then rose for virtually all portions of the population?

Mr. REISCHAUER. I think that is true, and quite rapidly, too.

Mr. OLVER. From 1975–1995, the last 20 years, have living standards and real incomes gone up for all portions of the population?

Mr. REISCHAUER. No, they have not.

Mr. OLVER. Who have they gone down for? Give me quintiles of the population. Who have they gone down for?

Mr. REISCHAUER. I do not have that data available, but the important thing to ask is what has happened to groups with various characteristics; those with less than a high school degree and those with a high school degree and no college, by and large, have had declining real incomes.

Mr. OLVER. Up to what level of education?

Chairman KASICH. The gentleman is sounding amazingly like me. If he would ask his question and then let the witness respond. He is kind of getting into a running debate here. It sounds like the way we used to do it years ago. Would the gentleman phrase his question and let the witness respond.

Mr. REISCHAUER. There is some recent information just published by the Census Bureau on this which is sitting on my desk. I have not looked at it and I do not know if it extends as far as those with 2-year college degrees or not. But the last time I looked at the evidence, it suggested that those with high school degrees had basically seen no improvement in their living standards. We are talking about individual workers adjusted for age. There is a different story for women than for men. By and large, women have done better at all educational levels than men have over this period.

Mr. OLVER. Have the living standards gone up for families of four, working white-collar/blue-collar, just average working families, recognizing that there can be quite different education levels there? But on average for families of four, traditional families who are in those categories, with whatever education, on average have they gone up in that last period of time?

Mr. REISCHAUER. If we are talking about the 1973–1994 period and you are making an adjustment for changes in the age composition, I think the answer is yes, but rather marginally.

Mr. OLVER. Thank you.

Chairman KASICH. The gentleman from Oklahoma, Mr. Largent.

Mr. LARGENT. Dr. Reischauer, we have been talking a lot about freezing current levels of spending or capping the growth, limiting the growth of the budget. I would like to ask you to really step out on your economic forecasting limb and look at this from the other side, because I believe we have a window of opportunity to make some dramatic changes. What happens if we do not? What if we freeze political posturing and rhetoric and continue down the same path we have been on? What happens then?

Mr. REISCHAUER. What happens then is that the deficit grows in relation to the economy, the resources available for investment do not grow as rapidly as they would otherwise, and that incomes and living standards, while they rise, rise at a very tepid rate, as has been the case in the past. There is not really a catastrophe looming in that sense, and that is one of the problems that we face. I mean there is no wall that we are going to hit. Our Nation, our economy, our people adjust gradually to this, but the future is much less desirable than if we take steps to reduce the deficit, increase saving and investment, and raise living standards.

Mr. LARGENT. When you say there is no wall you hit, that is really contrary to the typical businessman's mentality or my family's mentality. We do hit a wall when we continue year after year to spend more money than we have. There is a wall you hit. Why is that not true for the Federal Government?

Mr. REISCHAUER. At some point, if these increases in deficit were much more rapid than our forecasts suggest over the next decade, there certainly could be a wall. But I am suggesting that the deficit will gradually grow to 3.6 percent of GDP by the year 2005, and that is still a percentage of GDP lower than we have experienced in the last dozen or half-dozen years.

The fact of the matter is that we have a growing economy and it allows us to act in an irresponsible manner for a long time. We have a lot of wealth built up that we can sell to foreigners. We have an ability to limp along. It is not a desirable future, as I said. You as a businessman or a family unit have a finite life, have to depend on others for credit to a degree that the Federal Government does not have to.

Mr. LARGENT. Thank you, Mr. Chairman.

Chairman KASICH. Mr. Radanovich?

Mr. RADANOVICH. Dr. Reischauer, maybe this is just a comment on budgeting and how you build your forecasting models, but it would seem to me that some of the assumptions are based on a certain level of expectation of the American public in their response to policies that come down from the administration.

I guess my comment is: Do you believe, at least in your forecasting, that Americans respond positively to lower taxes? If you decrease taxes, are they more productive? And doesn't it seem that, I am very firm in the concept that we are going to balance the budget and reduce taxes at the same time. Now, if you are budgeting, budgeting is based on past experience, and I think the role of

the Budget Committee and this group is to take a look at how we expect the American people to respond to the policy that we are handing out. Being an economist, how do you base how people are going to react to policies like that?

Clearly, this is going to happen by creating a more productive American public in order to pay off debt and eliminate deficit. You are an economist. Tell me how you are going to qualify how Americans are going to respond to lower taxes and less regulation? I think the responsibility of this Budget Committee is to increase the level of expectation of the American public in response to lower regulation and lowering taxes.

Now, your models are based on past behavior, and this committee's responsibility is to expect a different set of behaviors out of the American public than these last 40 or 50 years.

Mr. REISCHAUER. Let me just say that our projections here assume that current policies remain unchanged, and so for the projections that is not a relevant issue.

You are saying that if we radically changed the structure of our tax system, would that have impacts on the savings, investment, and work behavior of the American people, and the answer is yes. It would depend on what specific changes you instituted. There is a good deal of economic literature trying to isolate these types of impacts. It is very ambiguous literature. Some people say that the impacts are big, others say they are small, some say they are positive, some negative.

There also is the issue that when you do cut taxes, while you can expect some of the revenue loss to be offset by behavioral changes, there is still some revenue loss. If that revenue loss is not compensated for by cutting spending further, it represents an increase in the deficit, an increase in the amount that the government takes out of that private pool of saving, and that has just the opposite effect on the economy and could offset some of the behavioral responses that you and I would regard as positive.

Mr. RADANOVICH. My statement is that if we hope to balance the budget, we must expect a behavioral change out of the American public. You have got to codify that change somehow.

Mr. REISCHAUER. That is true, but it would be wrong, I think, to pin your hopes on a large behavioral response occurring in a short period of time and making the cuts that you have to make substantially lower than they otherwise would be. Some of the benefits, particularly the ones related to increased saving and investment, accrete very gradually to the economy. Others, such as labor supply responses, are likely to accrue much more quickly, in a year or two. So there is a difference here and one worth pursuing.

Mr. RADANOVICH. I think that in our assumptions—and maybe that is the responsibility of this committee as far as educating the American public—clearly we are going to have to see a rise in the expectations of the American people. If we are going to do this and succeed in it, that is what is going to have to happen.

Chairman KASICH. The gentleman from the Steel City, Mr. Coyne.

Mr. COYNE. Thank you, Mr. Chairman.

Dr. Reischauer, we are often reminded here in Congress that we are a low-savings-rate nation, and on occasion we are asked to

build incentives into the Tax Code to try to remedy that and give incentives for people to save. My concern is who does that really help? Is it likely that low-income people or moderate-income people are the ones that are able to take advantage of that? Do you have any research, or is there any indication that they do? Chairman Sabo said that half of the jobs in Minnesota are at the livable wage, at the \$20,000 or below level. I think that is the figure he cited. Is it likely that those people can take advantage of an incentive in the Tax Code to save and, as a result, take advantage of a Tax Code deduction, or do you have research like that?

Mr. REISCHAUER. They are much less likely to take advantage of such an incentive, and one has to remember that, for certain provisions that have been suggested, incentives already exist for moderate- and low-income people, specifically with respect to IRA's. People can deposit funds in an IRA and get the tax advantage right now. It is only those who earn over about \$40,000 who are limited, if they are covered by a private sector pension plan.

Mr. COYNE. Thank you very much.

Chairman KASICH. Mr. Hobson?

Mr. HOBSON. Thank you.

Dr. Reischauer, when I was in the business world, my partners used to tell me if it is good times you start preparing for the bad times, because they are going to be coming, no matter what. I think you kind of suggested we have kid of that opportunity today.

I was interested in two things I want to talk about. One is explain to me this number again—and maybe I misheard it—the .04 percent of 1 percent. How does that relate? Did you talk about that in your opening statement? If we did .04 percent—

Mr. REISCHAUER. .04 percent of GDP fiscal restraint, that number?

Mr. HOBSON. Yes.

Mr. REISCHAUER. Economists try to measure how much stimulus or restraint the Federal budget is exerting on the economy and they measure this as the change in the structural deficit measured against the potential GDP. When we adopted the 1990 and 1993 deficit reduction packages, the Federal Government imposed restraint on the economy, because it was raising taxes and cutting spending, and that would cause the economy to slow down. At other times, government policy has stimulated the economy.

I was suggesting that over the 7-year period of the illustrative path that I gave you, if we went on a march to balance the budget, we would be exerting about 0.4 of a percentage point of restraint, slowing down the economy each year. The 0.4 percent is not very large. When we have exerted fiscal restraint in the past to slow down the economy, it has averaged something like 0.7 of a percentage point. But it has generally lasted only for a year or two, and we do not have any experience with a long sustained period in which the government tries to restrain the economy.

I suggested that there would be offsetting effects and that interest rates would fall and exports would rise because of the expected fall in the value of the dollar. Furthermore the Federal Reserve, seeing this deficit reduction package, would probably ease monetary policy, so much of that restraint would probably be offset. That is all I was trying to bring out.

Mr. HOBSON. I think that was a very significant thing and we are looking at that.

I want to talk about two of the areas that I think we have got some problem in, and that is in Medicare and Medicaid. In the 1960's, before the introduction of Medicare and Medicaid, we looked at health care at about 6 percent of GDP, and it was claimed at that time that Medicare and Medicaid would actually lower, which we know it did not.

Now we are looking at about 14 percent of GDP and projections up to maybe 18 percent. Would you say the government finance of health care has been effective in lowering spending or not?

Mr. REISCHAUER. No. Obviously, the Medicare and Medicaid programs have added to the growth of spending. They have provided medical services to groups of people who did not have access to the same medical care that the rest of society was enjoying.

Mr. HOBSON. So if we make some systemic changes, you might see—I think it was Mr. Hoekstra and Mr. Smith both saying that you may have some cultural changes, if we could make some systemic changes in those programs that might actually cause things either to level off or go back. You do not have to comment on that.

One of the things that bothers me is that, in your baseline projections, you assume that the annual growth of Federal Medicaid will decline from an annual rate of about 11.3 in 1996 to about 19.9 in 2000. You were not projecting that a year ago, I do not think. I guess what I would like to know is why are you now forecasting a slower Medicaid? Is that the result of things you are hearing or that States are going to do? Because it is a change from where you were.

Mr. REISCHAUER. It is a result of two things. First of all, our estimate for Medicaid spending during 1994 turned out to be too high by several billion dollars, so we lowered the base from which we were projecting. Then, because there had been a substantial slowdown in Medicaid spending and because of the various changes that are taking place at the State level, we decided that it would be prudent to lower our expectations about future Medicaid growth.

But I would say that all of this is terribly uncertain. A number of States have waivers, and under those waivers they are trying to put the Medicaid population under managed care of one form or another. At the same time, officials are trying to expand the number of people in Tennessee or Oregon or Ohio who are covered by Medicaid, and we really do not know how this is going to come out.

Mr. HOBSON. So you would agree there is still a lot of uncertainty in this area and your down projection may not turn out? There is a lot of disagreement among professionals who look at this, I think you will agree.

Mr. REISCHAUER. That is right, and we have seen that Medicaid spending rates can jump around a good deal. Several years ago, they were at 28 percent a year, and now they are down at 8 percent or 9 percent.

Mr. HOBSON. Just one last thing. Medicare beneficiaries believe they pay the entire cost of their Medicare benefits. However, the actual ratio plus premiums paid is a lot different. How do you look at the typical Medicare beneficiary?

Mr. REISCHAUER. The typical Medicare beneficiary is receiving a very substantial subsidy from both the general taxpayer and current workers. From the general taxpayer, in the sense that the Part B program is sustained by two flows of resources, the first being a monthly premium that the participants pay, and that next year will amount to only 25 percent of the full cost. The second is a transfer from general revenues that will pick up roughly three-quarters of the total. The Part A program—the hospital coverage—is financed out of a trust fund supported by a payroll tax. But the average beneficiary, those who are now receiving benefits, contributed into that trust fund an amount that is far from sufficient to pay for the benefits that they are expected to receive in their retired years.

Mr. HOBSON. This is my last comment. If you could play devil's advocate in this or you were playing king, as John talks about or he likes to play, how would you address this problem of Medicare and the problems as we look out, the increasing population? How do we get control of this? If you look at it from a medical standpoint, there is no pressure for cost-effective medicine to be delivered, and there is a constant increase in going out and seeking services. How would you do this? Do you have any thoughts on that?

Mr. REISCHAUER. If you think that is the primary problem, you can try to move Medicare into a managed care type of program. Right now, it is the last bastion of unrestricted fee-for-service medicine. That will not be easy to do, but that is one possibility.

The other possibility is to provide the current beneficiaries with greater incentives to economize. We have certain parts of Medicare, such as some laboratory fees, for which no coinsurance is required. We can impose coinsurance or raise coinsurance amounts. We could change deductibles. The deductible now is \$100. That is a mere shadow of what it was when the Medicare system was set up in real terms and is also quite a bit below the deductibles that most of us face. So you can in a sense "incentivize" the beneficiaries.

The third approach is simply to raise the fees, the premiums that are charged participants, particularly those who are able to bear the larger burden. I believe the premium in Part B is roughly \$40 a month. That is not an insignificant amount of money for most of these people. As I said, it covers between one-quarter and one-third of the cost of the program, and we could raise it back up to the 50-percent level that existed when the program was established in 1965.

Mr. HOBSON. Thank you, doctor. Those are good comments.

Chairman KASICH. We are going to go to Wally Herger and then Mrs. Woolsey.

Mr. HERGER. Thank you very much, Mr. Chairman.

Dr. Reischauer, as you recall, over the last several years during 1993 and 1994, there was a lot of questions on this committee as to just what the ramifications would be of this 1993 OBRA, the Clinton tax bill which many termed the largest tax increase in our Nation's history.

I was just looking at your testimony on page 8, where you indicate that our projections for deficits for 1995 through 1999, that 5-year period of time, will be almost \$25 billion a year higher than

what you had previously anticipated just the preceding August. That amounts to approaching \$125 billion more in deficits than what we had projected at that time.

I guess my question to you would be, why is that the case, and does your forecast of this slower economy in 1996 down to 1.9 percent growth of GDP reflect perhaps the impact of the fully phased-in 1993 OBRA tax bill?

Mr. REISCHAUER. By and large, the increase in our deficit outlook over the next 5 years can be attributed to the higher interest rates that we have experienced. If you look at our projections out to the year 2004, you actually see that we have lowered our estimate for the deficit in 2004 from where we thought it would be in August of this year.

Mr. HERGER. I just want to make sure I understand that. Now, on the outside years, you are saying it is actually coming down, and on these 5 years prior to that they are going up? I want to make sure I understand that.

Mr. REISCHAUER. On average, I believe the deficits between 1995 and 1999 average about \$25 billion higher than we projected in August, and, as I said, in large measure because interest rates have gone up and a few other technical factors have changed, not because policy has changed, or because Congress has passed legislation that was not enacted or was not expected.

I then said that if one looks at the period beyond 1999, the difference between what we thought the deficit would be in August and what we now think it will be narrows. By the last year of that projection period, 2004, I believe the deficit is actually less than we thought it would be. But I would not make a whole lot out of this. These numbers, as you point out from your original statement, are highly uncertain. When we are talking about the deficit, we are talking about the difference between revenues that are roughly \$1.3 trillion and spending that is \$1.5 trillion. So small percentage errors in spending or revenues can cause huge swings in the deficit.

The second part of your question was whether the slowdown we anticipate in the economy could be attributed to the tax increases that were imposed in 1993 and have been phased in. My answer to that is no, that the slowdown in the economy will be attributable to the tightening that the Federal Reserve has undertaken over the course of the last year in an effort to slow down the economy. The Fed, like many economists, felt that the economy was operating at full capacity and growing at a faster than sustainable rate. So it is the direct result of monetary policy changes.

Mr. HERGER. Thank you.

Chairman KASICH. Mrs. Woolsey?

Mrs. WOOLSEY. Thank you, Mr. Chairman.

I would like to follow, Dr. Reischauer, on what my colleague Mr. Olver was talking about and what Mr. Sabo talked of and Carrie Meek. With one out of seven children living on welfare and with the physical labor force having less and less value, and with many college graduates not being able to find jobs, with benefits, that actually pay a livable wage, I have three questions that I think would help me, if you have any studies that you could respond with.

One, what level of minimum wage would bridge the gap for entry-level workers, for individuals we need to get off welfare permanently, and for college graduates that actually are still living at home with their parents—an example here.

Two, are there really enough high-skilled jobs that pay a livable wage out there? If so, do we have enough workers trained for them? Finally, particularly if we do not have enough workers trained, what is the effect that the Republicans' contract has on all of this, when one of the end results of the contract will probably be cutting campus-based student aid?

Mr. REISCHAUER. Minimum wage by historical standards, in real terms, the minimum wage is fairly low. The latest economic research suggests that the disemployment effects of raising the minimum wage are less than economists thought several years ago. In part, this might be because the wage is low in relation to what it has been in the past. Nevertheless, I think most economists, myself included, believe that increases in the minimum wage have some disemployment effects. That is, fewer people will be employed as a result of a higher minimum wage.

Over the course of the last few years we have significantly increased the earned income tax credit and expanded that tax credit to workers who do not have children. In a sense this should provide some stimulus and encouragement to join the labor force and work even at jobs that pay not a living wage, to use Mr. Sabo's term. I certainly do not think there should be a separate minimum wage for college graduates. I think one minimum wage is enough, although we do have a minimum wage for students that is slightly lower, and I would question the desirability of that.

Are there enough high-skilled jobs out there? Certainly, many people would like there to be more demand for their services; for example, recent college graduates. I share your burden. I have had both of my children at home for various periods of time. I often question whether that was the result of a market changed from when I was a young person or changed expectations on their part. They seem to want to leap directly into suburban middle-class lifestyles, rather than live in the genteel squalor that I lived in when I was their age.

The distribution of jobs is going to be determined largely by technology, and I think there is very little that the government can do to affect it in a substantial way. You asked whether there were enough people trained for the high-skill jobs, and there certainly are pockets where there is excess demand, but, by and large, looking at the recent college graduates—many of whom are quite capable and still having a difficult time finding a job—I think one would have to conclude that maybe, we have, if anything, an excess supply of highly skilled labor or skilled labor—I would not say highly skilled—the B.A.-level individual.

I think the country falls short in developing individuals with high school skills in reading and mathematics that are needed in the workplace below the college level.

Mr. SHAYS [presiding]. I need to kind of move things along here, if you want to wrap up.

Mr. REISCHAUER. I will come right to the bottom line, which was what impact will the Contract With America have on all of this. I do not know. [Laughter.]

Mr. SHAYS. Let me tell you, just in terms of order, Mr. Bunning will be next, and then Mr. Bass, Mr. Orton, then Mr. Miller and then myself, unless you have some questions—

Mr. SABO. I might.

Mr. SHAYS. Mr. Bunning?

Mr. BUNNING. Dr. Reischauer, it is amazing that when I went through college and took economics I learned that full employment was good, low interest rates were good, low inflation was good, 4 percent annual growth was good. Fiscal and monetary policy seem to have changed those things. I just say that off the top of my head.

Mr. REISCHAUER. I think they are all good now.

Mr. BUNNING. They are.

Mr. REISCHAUER. Yes, it's just that sometimes they are not all attainable at the same time and you have to have a tradeoff.

Mr. BUNNING. I learned they were good all the time and that full employment was good and people working was good, and the gross national product advancing 4 percent annually was good. I thought that is what economic policy and fiscal policy that the House of Representatives was trying to implement would be helpful.

Let me ask you some questions. What will be the national debt—it is probably in this thing and I have not had a chance to go through it—by the year 2002, if we actually balance the budget, without changing the way we include the Social Security Trust Fund as an offset and the Highway and Aviation Trust Fund as an offset? What will the national debt be in the year 2002, the number?

Mr. REISCHAUER. Go to the next question. We are having this one calculated for you.

Mr. BUNNING. What do you anticipate the interest on the national debt will be in the year 2002? In other words, what will we be paying on an annual basis?

Mr. REISCHAUER. With a balanced budget?

Mr. BUNNING. No. First of all, I have got to have a number. If interest rates are 5 percent, we can figure out the number.

Mr. REISCHAUER. Do you want this in billions of dollars?

Mr. BUNNING. I want it in trillions, actually. You are going to have trillions of dollars as far as the national debt is concerned in the year 2002, if we just continue on. If we do balance the budget by the year 2002, we will have added X amount of dollars to the present \$4.7 or \$4.8 trillion, depending on who you ask what the debt is presently. I want to know a number.

If you have difficulty looking that up, I will ask you some more different questions.

Mr. REISCHAUER. Keep going.

Mr. BUNNING. We are hearing a lot about trade surpluses and trade deficits. Is it true or is it not true that a trade deficit, say going from a trade surplus with Mexico to a trade deficit with Mexico, affects the bottom line of our debt directly?

Mr. REISCHAUER. I do not think you can say anything with respect to a single country.

Mr. BUNNING. Well, I am just using that as an example. I am talking about the overall trade deficit, obviously. In other words, if we have a trade deficit of \$150 billion, does that go to the bottom line of the deficit and the bottom line of the debt?

Mr. REISCHAUER. You want to know what is happening to the current account deficit. If the current account deficit increases, then the resources that we owe to foreigners increases or the net wealth of our country, if we are in a creditor position, decreases.

Mr. BUNNING. So the answer to the question is yes?

Mr. REISCHAUER. But we believe we are in a net debtor position right now and the net debt would increase.

Mr. BUNNING. It would go to the bottom line directly?

Mr. REISCHAUER. Yes, with some financial transaction adjustments.

Mr. BUNNING. Have you come up with an answer on those other things? I think that is important, if we are going to start—

Mr. REISCHAUER. The debt held by the public would be \$4.347 trillion.

Mr. BUNNING. You are going to reduce the debt to the public.

Mr. REISCHAUER. No. You asked me what the debt owed to the public in 2002 would be, if we balanced the budget.

Mr. BUNNING. So there is going to be a net reduction of—

Mr. REISCHAUER. That is according to the path that we had laid out. We would have debt owed to the public of \$4.347 trillion. Right now, it is \$3.617 trillion, so it would increase by less than a trillion.

Mr. BUNNING. Why do we say it is \$4.8 now?

Mr. REISCHAUER. You are talking about gross debt?

Mr. BUNNING. That is correct. I am asking you that number.

Mr. REISCHAUER. Not debt held by the public?

Mr. BUNNING. That is what I am asking you, what will be the gross debt in the year 2002.

Mr. REISCHAUER. We have not calculated that, because we do not carry the Trust Fund surpluses out to the year 2002.

Mr. BUNNING. You do it 5 years, though?

Mr. REISCHAUER. Yes.

Mr. BUNNING. Can you give me that number, even if we do not go to 2002? What I am trying to get at is, even if we do get on a down slope, that we are going to owe a lot more money by the year 2002 and the interest on that debt is going to be obviously the largest item in our budget in the year 2000, 2001 and 2002.

Mr. REISCHAUER. Social Security will be larger, but we will pay close to \$300 billion for interest on the debt.

Mr. BUNNING. And if we still have fiscal and monetary policy of the Fed manipulating the interest rate that they have six times in a year or seven times—I do not know what they did today, if they raised it half a percentage point—to try to manipulate our economy, we could have as much as a 5 to 10 percent interest rate at that time on a \$6 trillion debt? Is that correct?

Mr. REISCHAUER. I think it would be difficult to envision a 10-percent average interest rate on Federal debt.

Mr. BUNNING. Did not your projections last August have a much lower interest rate projection, and that is the reason we have a \$125 billion increase in the projection?

Mr. REISCHAUER. It is, but the Federal Government borrows money for as short as 3 months and as long as 30 years. All that money does not turn over every year. An increase in interest rates, which usually slows down the economy and then brings forth lower interest rates, does not affect the entire outstanding debt. It only affects that portion of it that—

Mr. BUNNING. Even on our 30-year bonds, we are at 7.75 as of yesterday afternoon, interest rate on 30-year bonds.

Mr. REISCHAUER. Yes, but the interest rate applies only to bonds that are being issued now.

Mr. BUNNING. That is correct.

Mr. REISCHAUER. All the 30-year bonds that have been issued before are not affected by the rise in interest rates.

Mr. BUNNING. Thank you.

Mr. SHAYS. Mr. Bass, you are next.

Mr. BASS. Thank you, Mr. Chairman.

Early on in this hearing, you discussed with Chairman Kasich the effect of balancing the budget and improving living standards. Mr. Largent brought up the converse or the obverse or whatever you want to call it, the failure to balance our budget will reduce in some form or fashion living standards, and Mr. Olver has talked about real living standards over the last 20 years, declining or remaining neutral amongst various income levels or education levels.

I am wondering whether you could complete that circle, if you will, and tell us how you think failure to balance the budget and the cost that would accrue or the reduction in living standards, how that would spread across socioeconomic levels. In other words, failure to balance the budget and its negative impact on living standards, would that affect any one sector of the population more than any other sector of the population?

Mr. REISCHAUER. I think that question is impossible to answer. One would expect between now and the year 2002 that living standards on average will probably rise by about 1 percent a year, maybe 1.5 percent. That increase would be fairly widespread and if you were to balance the budget, the number would not look a lot different over this 7-year period. If one looked 10 or 15 years into the future, one would expect to see living standards rising faster than they would under the baseline case. But how that distribution will be spread among those without a high school degree, those with a high school degree, and those with a college education, I think it is impossible to say.

Mr. BASS. Thank you, Mr. Chairman.

Mr. SHAYS. Mr. Orton, you have the floor.

Mr. ORTON. Thank you, Mr. Chairman.

Dr. Reischauer, it is good to see you again. I am one of those who supports balancing the budget and supports a balanced budget amendment. I have some concerns about the amendment we passed the other day and I would like you to comment on one issue, and that has to do with estimates of outlays and receipts.

Now, the amendment we passed requires us at the beginning of the year to estimate our outlays and receipts and set forth a budget that is in balance. There are then mechanisms to control outlays, to be certain that they do not exceed estimated outlays. However,

there are no mechanisms at all to guarantee receipts are as high as what we estimate them to be.

So, the following scenario is what I see as a probable likely scenario, given the balanced budget amendment and given our history. This is no negative reflection on you or the CBO, but as I have compared the last 15 years, we have missed in estimating revenues, we have overestimated revenues by an average of \$25 billion per year.

So the scenario as I see it that is likely to occur is as follows. We adopted a balanced budget amendment, we are in the year 2004, we have a permanent ceiling on the debt limit, we cannot increase it without a super majority. We estimate a balanced budget, we estimate revenues at a certain level, and outlays at a certain level. We are very diligent at watching outlays. In fact, we do not spend one cent over what we have estimated the entire year. We end up September 15 and we receive a report from Treasury saying, sorry about that, we are not getting all the revenues we thought we were going to get.

Now we are still out of balance, but the Constitution requires that we be in balance. The government cannot issue any new T-bills as the old ones come due, because we have a permanent limit on the debt. At that point in time, it is too late to cut spending any more. It has already been spent.

At that point in time, it is too late, whether you have a regular majority, super majority or whatever, to raise revenues. And if revenues were pegged optimistically and they do not all come in, we only have two choices: Technical default with all of the catastrophic economic circumstances that would bring, or increase the debt limit. And, we have just put in the Constitution that it takes a super majority to do so.

I guess I am asking for your response with regard to mechanisms that you see to guarantee receipts. Is my analysis wrong in pointing that out as a likely scenario?

Mr. REISCHAUER. No, I think your analysis is quite right. In fact, it is a little optimistic. When the fiscal year comes to an end each September 30, the government still does not know how much it has spent or how much it took in. It is not until about a month later that the Treasury Department gets to total up all of the revenues and spending and come up with an official estimate of the deficit.

Mr. ORTON. So the government really intends to——

Mr. REISCHAUER. The issue that you raised suggests that to be prudent, to avoid crises at the end of fiscal years or wrenching adjustments in various programs, such as withholding payments to States for various grant programs, delaying checks that might have gone out at the end of September, or withholding pay to the military or civilian work forces, you would have to operate with a margin. You would have to pass a budget and a budget plan that had built into it some surplus, so that——

Mr. ORTON. That is being less optimistic in receipts, rather than overestimating by \$25 billion average per year. We would be underestimating receipts to be certain that——

Mr. REISCHAUER. You have a contingency fund that you create in the budget.

Mr. ORTON. To be certain that the receipts are sufficient.

Mr. REISCHAUER. It would be very risky to adopt the budget that exactly balanced spending and revenues, unless you were below the debt ceiling.

Mr. ORTON. Then we have gotten to the point that I wanted to raise, which has to do with this whole concept of dynamic scoring. We held a joint committee meeting a few weeks ago, where many people suggested that we ought to be increasing our revenue estimates based upon certain activities and behavior in the economy, that our former system of static scoring scores revenues too low. Therefore, in order to adopt many of the provisions that people in this body want to adopt, we ought to score those as generating more revenue. Does that not exacerbate the problem, thereby creating an even more difficult situation at the end of the year, if revenues are not there? That is the concern I see.

Mr. REISCHAUER. Given the historical evidence that you presented in your chart, you would have to conclude that that would exacerbate a problem we have already, which is that the Congressional Budget Office has overestimated revenues on average over the last decade or so.

Mr. ORTON. When in fact we should be going in just the exact opposite, being more pessimistic in our estimation of revenues, so that we are certain we do not get into the situation at the end of the year where our only opportunity is either default or increase the debt limit.

Mr. REISCHAUER. You face differential penalties. If you err on the side of saying that there is no deficit in this budget, and it turns out to be a surplus, there is no punishment. If there is deficit, then you are in deep trouble, as you suggest.

Mr. ORTON. Thank you.

Mr. SHAYS. Mr. Miller?

Mr. MILLER. Thank you.

Dr. Reischauer, one of the bills I will be reintroducing next week is suspending the Reduction Commission, which is one vehicle to get us to the balanced budget, because we need to have a way to get to it. My question, to continue along this area, is the scoring issue, and my question is going to focus on the problem of scoring driving policy.

You agree that we need fundamental policy changes to reach certain goals of balancing the budget. In particular, I want to focus on health care, and that has come up a couple of times. I remember in the health care debate last year, I opposed the Clinton health care bill. Your scoring or inability to score certain areas made it favorable for us to oppose that program, managed competition, malpractice, if I am not mistaken you would not score. It is not for lack of ability. I fully understand how you cannot really score something like that.

Speaker Gingrich spoke yesterday to the American Hospital Association and was saying we need to rethink the whole Medicare program. When Mr. Hobson asked you the question about how do you go about changing saving money in Medicare, you mentioned coinsurance. There are scorable things. You did not mention managed care, which I do not think you have scored yet.

At any rate, how do we move to go for fundamental changes and not have scoring driving our decisions? It is very important. We do

not want to make mistakes, as Mr. Orton said, on the revenue sides of scoring. We really need fundamental change over the period of time, but we do not necessarily have the numbers to fully make those changes. How, as legislators, should we incorporate scoring versus—it is not dynamic versus static, it is just—

Mr. REISCHAUER. I think we have been fairly straight with the Congress and indicated where there is a lack of data, a lack of information available. At instances like that, I think the Congress has to look at our cost estimate and say that they could count these things, or they cannot count those things because the data is not there, the research is not available. Are we going to waive the limitations that are imposed by the budget process?

But when you do that, you have to remember that you are going out on a limb where few have gone out before, and there is a tendency only to take such steps when they are in an optimistic direction and never when they are in a pessimistic direction. As I said, something like managed care could, under certain circumstances, lead to some savings in the Medicare program. There is not a great deal of research dealing with how much money can be saved in an HMO setting serving elderly patients. Elderly patients are different from those of us who have less intensive medical needs. I think it would be risky to assume that large savings are going to result from changes of this sort in a short period of time.

Mr. MILLER. We are talking about a vouchering system, which is further beyond the managed care.

Mr. REISCHAUER. If you went to a voucher system, that would be fairly easy to score. If you say you are going to give everybody a voucher, the voucher is worth X dollars, and anybody with a calculator can work out what the costs of a program like that would be.

Mr. MILLER. Malpractice insurance, you did not score that, did you, malpractice changes? It seemed like at one time you were not going to score that. We all know that changes in malpractice should save money on defensive medicine. I understand the problem of scoring. You know it is going to save money, but yet you cannot score it, so you do not do it.

Mr. REISCHAUER. That is a little strong. The President's plan, if you remember, had limits on premiums and the growth of premiums. Those were sufficiently low that we thought they would be the constraining element in the President's plan. Managed care, managed competition, and malpractice reforms could help lower costs, but they would not lower the costs below what these premium limits would be, and so further steps would have to be taken. That is the only decision we had to make with respect to the President's plan.

Many of the plans actually were fairly limited in their liability reforms, and were not the type of thing that would have saved gobs of money.

Mr. MILLER. Just to conclude, we need fundamental changes in health care especially, I think, and we need to be risk-takers, and I commend the President for trying to take a risk.

Mr. REISCHAUER. You have to remember that most of what social scientists do is look at the past and past behavior changes as a result of changed incentives to project the future. When you are talk-

ing about systemic reform—going to entirely different systems of organizations, different institutions—you cannot expect very accurate or informed estimates from social scientists.

Mr. MILLER. I am not criticizing.

Mr. REISCHAUER. I know.

Mr. MILLER. I am just saying it is a policy thing. Thank you very much.

Mr. SHAYS. Mr. Browder?

Mr. BROWDER. Thank you, Mr. Chairman.

Dr. Reischauer, I would like to return to the issue raised by Mr. Stenholm, the middle-class tax cut. I have been with the Chairman at our two field hearings in Ohio and Arizona, and I asked the question of the audience by a show of hands. We have had large audiences, and I am sure these are not typical Americans, but they are interested in the budget.

I asked the question of whether they wanted to deal with our budget problems by raising taxes or cutting spending. Of course, we get the overwhelming answer to cut spending. I then asked a question about the middle-class tax cut and asked did they want a middle-class tax cut or did they want that applied to the deficit. It was interesting to me that overwhelmingly, great margins, 3-to-1, 5-to-1, maybe 9-to-1, they said they would prefer to have it applied to the deficit.

I think that if we are going to—this is my own personal statement before I ask you a question—if we are going to deal with the middle-class tax cut, and I think we realistically have to acknowledge that is a big train on a fast track, when the President and the majority party have both endorsed it—I think we have to apply three criteria to it: One, it has to be honest and the people have to understand about it; two, it has to be reasonable, we do not need to get into a bidding war and give away the store; and, three, it has to be smart, we do not need to encourage consumption by that, it would be investment.

Let me ask you, if we want to do a middle-class tax cut—I am sure we have this elsewhere, but I would like for you to articulate it here—what is the impact on the deficit of the tax cut in the range that it has been talked about? What is the impact on the deficit during the glide path that we are talking about, say to 2002?

Mr. REISCHAUER. I do not have any estimates of the costs of the components of the Contract With America on the tax side, because the Joint Committee on Taxation has not completed its analysis, other than those that the administration has provided. If we are talking about the \$500 per child tax credit—which I think would be the closest thing to the middle-class element of this—over the 1995–2000 period, the administration estimates it would cost \$124 billion. In the last year, 2002, the administration estimates that it would be a \$32 billion decrease.

Mr. BROWDER. I do not want to get into a discussion or an argument about the administration versus the Republican Party's estimate of it. We are talking about something that is a pretty sizable price tag or increases the deficit, regardless of whether we want to increase the deficit or keep the deficit neutral.

As we look at the blocks that are being considered that we have got on the table for addressing the budget problem, can you iden-

tify any blocks that are being considered that would be equivalent to the middle-class tax cut, just so the American people know what the alternatives are, if it is a tradeoff, if it is a middle-class tax cut or this over here, if we want to either keep it deficit neutral or if we are going to add it to the deficit, we are adding the equivalent of another block? Have you given any thought to that? I know you are not in the business of talking about public policy choices.

Mr. REISCHAUER. I have not specifically, but just let me say that the cost that I just gave you of about \$32 billion in the year 2002, would be roughly one-half of the Medicare cuts that were included in the President's health care proposal. So we would be talking about very substantial cuts in the Medicare program, if that were used to offset middle-income tax cuts.

Mr. BROWDER. Do you know of any other equivalencies that you—we are not making decisions about either/or here, but do any others pop up in your mind?

Mr. REISCHAUER. I can give you for the record a list of deficit reduction items that would be equivalent to the rough cost of the middle-class income tax cut.

Mr. BROWDER. If you could, I would appreciate that.

Thank you, Mr. Chairman.

[The information referred to follows:]

The attached table shows CBO's estimate of savings from several proposals for spending cuts that will be included in CBO's forthcoming volume, *Reducing the Deficit: Spending and Revenue Options*. Various combinations of these proposals would produce savings approximately equivalent to the \$124.1 billion that the administration estimates the tax credit of \$500 per child would cost over the 1996–2000 period.

CHILD TAX CREDIT AND ILLUSTRATIVE SPENDING CUTS
THAT COULD BE USED TO OFFSET REVENUE LOSSES
(By fiscal year, in billions of dollars)

	1996	1997	1998	1999	2000	1996- 2000
Revenue Losses						
\$500 per child tax credit ^{1a}	13.4	27.0	27.2	27.4	28.9	124.1
Illustrative Spending Cuts						
Charge market prices for electricity sold by power marketing administrations	0.0	-1.0	-1.0	-1.0	-1.0	-4.0
Lower target prices for farmers participating in commodity programs	-0.5	-1.4	-2.4	-3.3	-4.2	-11.8
Charge all Stafford Loan borrowers interest while they attend school	-1.6	-2.5	-2.6	-2.8	-2.9	-12.4
Increase Medicare SMI deductible and index to growth in SMI costs	-0.9	-1.6	-2.1	-2.6	-3.2	-10.4
Charge 20 percent coinsurance on Medicare home health and skilled nursing facility services	-2.6	-4.4	-5.1	-5.6	-6.2	-23.9
Increase Medicare SMI premium to 30 percent of program costs	-2.6	-3.9	-4.4	-6.3	-9.0	-26.2
Adjust COLAs and tax code by CPI - 0.5 percentage point ^{1b}	<u>-2.2</u>	<u>-6.1</u>	<u>-11.0</u>	<u>-16.4</u>	<u>-22.2</u>	<u>-57.9</u>
Total	-10.5	-20.8	-28.6	-38.1	-48.6	-146.5

SOURCE: Congressional Budget Office; Department of the Treasury.

NOTE: Numbers may not add to totals because of rounding.

SMI = Supplemental Medical Insurance
COLAs = Cost of living adjustments
CPI = Consumer price index

^{1a} Revenue estimates are by the Department of the Treasury. Revenue losses are shown with a positive sign because they increase the deficit.

^{1b} Includes increased revenues from change in indexation of tax brackets, the personal exemption, the standard deduction and the earned income tax credit. Increased revenues are shown with a negative sign because they reduce the deficit.

Mr. SHAYS. I thank you as well, Mr. Browder.

Mr. Sabo would like to ask some questions.

I appreciate you staying, Dr. Reischauer. I know it has been over 2 hours, but we are coming to a close here.

Mr. SABO. Thank you, Mr. Chairman.

Let me come back to the question of what the impact on a balanced budget amendment would be on debt management. I think there is a very significant difference between whether you get to a balanced budget by policy or whether you get there by requirement of the Constitution, and it particularly relates to what you do with debt management.

I see no alternative for Congress, if we are there by constitutional requirement, other than turning all debt into long-term debt, just to eliminate the volatility in interest costs from year to year, in terms of any prudent management.

Our history during Gramm-Rudman, when we operated with certain specified targets was that the administration tended to underestimate interest costs and move to short-term debt to get to the temporary target of the particular year. But for any prudent management in the long term, I think you have to go to long-term debt to minimize that volatility.

I think the other fact is that——

Mr. REISCHAUER. At the same time, as you did that, you would raise interest, debt service costs.

Mr. SABO. Yes, because historically long-term debt had higher rates than short-term rates. There are rare exceptions in history where that has not been the case. So in terms of any analysis of the impact on interest costs of living with a balanced budget amendment or constitutional requirement, in contrast to a policy, I think there could be a significant impact on long-term rates or on the degree you depend on long-term financing.

What the spinoff effects are I do not know. To what degree there is a certain given market in short-term debt versus a market of long-term debt, but clearly we would move in massively larger fashion into long-term debt, and what that impact would be on the totality of long-term debt financing in our country, I do not know. Frankly, I think it is something that we need an analysis of.

With the other uncertainty added in, clearly, even if you achieved a balanced budget, you still would at times have to adjust debt ceilings. If you missed targets for things like cash-flow problems—I think normally October and November are low cash-flow months—and with the prospect that it is not easy to get a 50-percent vote, I am not sure what the impact would be if one did not get 60 percent for an increase of the debt ceiling that was simply needed to refinance or accommodate the cash-flow problems. It could be substantial.

Particularly on the question of moving to total long-term debt financing, have you done any studies on what impact that would have? Not only on interest costs, but also what would its impact be on other long-term debt securities in this country, both State and local government issues and also the private sector?

Mr. REISCHAUER. We have not. The studies that we have done have been in the opposite direction; what the savings would be

from moving to shorter maturities. So it has been just the opposite problem.

Mr. SABO. If you do not operate with a constitutional requirement, I frankly think there is some fiscal prudence in moving to short-term financing. But if you are operating with a constitutional requirement, I think prudence tells you that you have to move in the other direction. Otherwise, the agencies that are determining the year-to-year budget becomes Federal Reserve and the international bond dealers. They may be governed by the facts and they may be motivated by myth, and one is not sure what happens to that market on a year-to-year basis.

Mr. REISCHAUER. Even if you were able to eliminate the volatility in the interest payments that the government makes through a mechanism such as going to virtually all long-term debt, the budget contains other volatile elements—unemployment insurance, revenues, food stamps—that will rise and fall with the economy. Those uncertainties alone will create a situation such as Mr. Orton was referring to, in which you probably would have to have some sort of reserve fund or some cushion built into the budget that you pass each year.

Mr. SABO. But those at least are adjusting in relationship to reality. The other may be shifting in response to reality or they may be shifting in relationship to perceptions of reality, and that is somewhat different.

Mr. SHAYS. Ms. Woolsey, do you have any questions?

Ms. WOOLSEY. No questions.

Mr. SHAYS. Dr. Reischauer, our staff corrected me. It is not 3 hours, it is 2 hours.

Mr. REISCHAUER. I thought I was just having so much fun that it seemed like only 2 hours.

Mr. SHAYS. I just marvel at the thought that you have had to testify before so many committees over the years, and I appreciate your willingness to do that.

My questions relate to some very quick points here. You gave a very helpful list to Mr. Hobson on ways to reduce our medical costs on Medicare and Medicaid in terms of making them in some cases copayment and in some cases health maintenance approach, and so on. Were there any that you mentioned that you would not recommend? In other words, you mentioned a list and they all seemed very plausible to me, politically difficult in some ways, but very plausible and fair. Were there any that you would caution us against considering that you mentioned?

Mr. REISCHAUER. No. By and large, these are proposals that the Congress has considered many times in the past and has sometimes adopted to a partial degree. If one starts with the premise that one has to reduce Medicare, these are the most reasonable ways of going about it.

Mr. SHAYS. I think that, at least on our side of the aisle, we think it is absolutely essential that we are going to have to, because otherwise we will make to make cuts in what is really a freeze in discretionary spending for 5 years. When I have people argue to me that I hope you do not cut aid to private schools, because then you are going to make the public schools more dominant, and so on, my point to them is do not get on our backs if we

have to make some prudent reductions in the growth in Medicaid and Medicare.

I am looking at a 5-year increase over the 5-year plan of the President, not in a critical way, just pointing this out, but just in terms of we are on a hard freeze in discretionary spending, Social Security goes up about 30 percent, other entitlements will go up about 52 percent, and interest on the national debt is going up 40.2 percent. I am thinking of two points.

Is there any entitlement that you think we could make an annual appropriation, instead of putting on automatic pilot, is there any that come to mind that would be easily transferrable to an annual appropriation?

Mr. REISCHAUER. By their nature, if you did that, they would not be entitlements.

Mr. SHAYS. The reason why I view it as an entitlement, the problem—

Mr. REISCHAUER. An entitlement basically guarantees an individual or a business or a State—whatever the beneficiary happens to be—a benefit if certain circumstances occur or certain eligibility criteria are met, and so the individuals or the beneficiaries design their behavior and their lives that way. They expect to get unemployment insurance if they lose their job. They expect to get health benefits if they turn age 65. They expect to be able to get a student loan.

Mr. SHAYS. I get the sense of that. What I am trying to do is find out—and I guess I am asking a question I pretty much know the answer to—but the challenge to entitlements, are they truly on an automatic pilot, so as a representative of my constituency, I weigh in on a third of the budget, I do not weigh in on 50 percent unless I change an entitlement.

So you would basically concur that there is a practical problem with making an entitlement an annual expenditure, because I am assuming the money could run out in November or September, and so on. Has any State devised a way to get around that problem, in other words, constant adjusting of the benefits, so that if they tried to estimate that every month there would be so much drawn, and if more was drawn, then they would reduce the benefit the next month to try to make sure that they would be able to go through the entire year on a fixed amount?

Mr. REISCHAUER. I think some States might have done something of that sort with the adjustments that they have made to their AFDC payments—how much they are going to increase them by during the year, not sort of where they were at the very beginning of the year. I am not positive about that, but I vaguely remember something of that sort.

When you are dealing with entitlements, you have the choice of reducing the benefits, the scope of the benefits, or reducing the number of people eligible for these benefits. Your third approach—transforming the entitlement into a discretionary program where there is no guarantee—you have to ask yourself whether it is desirable to have a society in which certain things can be counted on, can be expected, and whether the entitlement nature of the program is worth preserving.

Mr. SHAYS. We have concluded this hearing. Is there any last comment you want to put on the record?

Mr. REISCHAUER. Only that I have enjoyed working with this committee over the last 6 years and I hope that CBO will maintain a constructive relationship with the majority and the minority, as the 104th Congress meets what is really an overwhelming challenge.

Mr. SHAYS. I would just say to the Director that I know that this committee appreciates the work you have done on both sides of the aisle, and I am sure when people look back over the work you have done, they will say you did it with a tremendous amount of skill and dedication.

Thank you very much.

This hearing is adjourned.

[Whereupon, at 12:54 p.m., the committee was adjourned.]

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